ACCA

Professional Accountant

Paper P1

Course Notes

ACP1CN08(J)

BPP LEARNING MEDIA

P1 Professional Accountant

Step 1 – Learning Phase Study Programme

Step 2 – Practice and Revision Phase

BPP provides a range of revision courses and materials to support this important phase of your studies in which you develop your exam skills.

Step 3 – Rehearsal phase

For that vital final rehearsal BPP offers Question Day Courses and Final Mocks with online debrief.

Introduction to Paper P1 *Professional Accountant*

Overall aim of the syllabus

To apply relevant knowledge, skills and exercise professional judgement in carrying out the role of the accountant relating to governance, internal control, compliance and the management of risk within an organisation, in the context of an overall ethical framework.

The syllabus

The broad syllabus headings are:

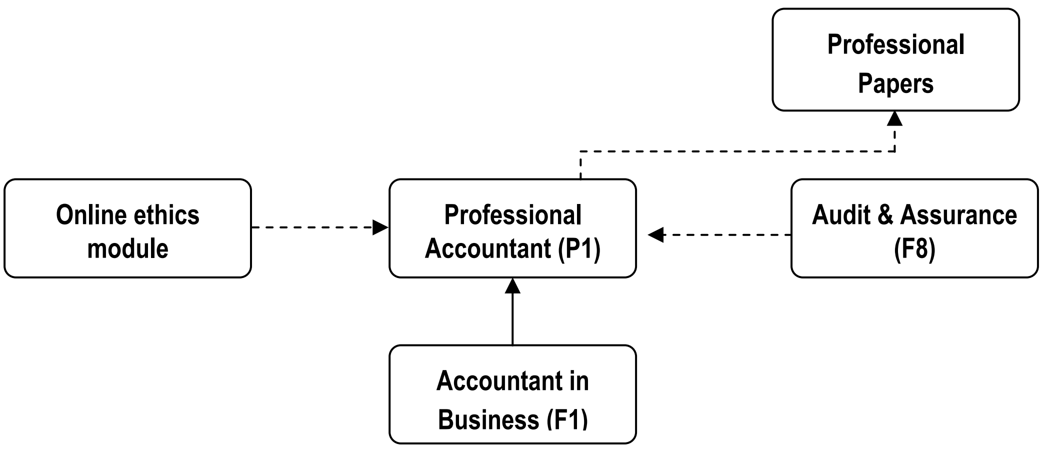
A	Governance and responsibility
B	Internal control and review
C	Identifying and assessing risk
D	Controlling risk
E	Professional ethics and values

Main capabilities

On successful completion of this paper, candidates should be able to:

- Define governance and explain its function in the effective management and control of organisations and of the resources for which they are accountable;
- Evaluate the professional accountant's role in internal control, review and compliance;
- Explain the role of the accountant in identifying and assessing risk;
- Control and mitigate risk;
- Demonstrate the application of professional values and judgement through an ethical framework that is in the best interests of society and the profession, in compliance with relevant professional codes, laws and regulations.

Links with other papers



This diagram shows where direct (solid line arrows) and indirect (dashed line arrows) links exist between this paper and other papers that may precede or follow it.

The Professional Accountant syllabus assumes some of the knowledge acquired in papers F1 *Accountant in Business* but develops and applies this further and in greater depth. There is also the presumption that students will have completed the online ethics module. The ACCA consider Paper P1 *Professional Accountant* to be the gateway paper to Professional level studies, as it provides valuable information for all other papers.

Assessment methods and format of the exam

Examiner: David Campbell

The examination is a three-hour paper, with 15 additional minutes allowed at the start of the exam for reading and planning. It will be entirely discursive and some questions will adopt a scenario/case study approach.

Format of the Exam		Marks
	The paper is divided in to two sections	
Section A	**This ONE question is compulsory and MUST be attempted**	50
	This question is based on a detailed scenario, which provides a context for the answer to be applied to. The question will be sub-divided into several requirements, which could cover any number of parts of the syllabus in an integrative approach.	
Section B	**TWO optional questions from a choice of THREE are to be attempted**	2 x 25
	Each question will have its own small scenario; therefore all answers must apply knowledge in context. Each question will be sub-divided into several requirements; there were three in each question in the pilot paper.	
	Questions will be drawn from any part of the syllabus, but each one is likely to focus on one or two specific areas in detail.	
		100

Course Aims

Achieving ACCA's Study Guide Outcomes

A Governance and responsibility

A1	The scope of governance	**Chapter 1**
A2	Agency relationships and theories	**Chapters 1 & 2**
A3	The board of directors	**Chapter 3**
A4	Board committees	**Chapter 3**
A5	Directors' remuneration	**Chapter 3**
A6	Different approaches to corporate governance	**Chapter 2**
A7	Corporate governance and corporate social responsibility	**Chapter 10**
A8	Governance reporting and disclosure	**Chapter 3**

B Internal control and review

B1	Management control systems in corporate governance	**Chapter 3**
B2	Internal control, audit and compliance in corporate governance	**Chapter 4**
B3	Internal control and reporting	**Chapter 4**
B4	Management information in audit and internal control	**Chapters 5 & 9**

C Identifying and assessing risk

C1	Risk and risk management process	**Chapter 6**
C2	Categories of risk	**Chapter 6**
C3	Identification, assessment and measurement of risk	**Chapter 7**

D Controlling risk

D1	Targeting and monitoring risk	**Chapter 8**
D2	Methods of controlling and reducing risk	**Chapters 7 & 8**
D3	Risk avoidance, retention and modelling	**Chapter 7**

E Professional ethics and values

E1	Ethical theories	**Chapter 10**
E2	Different approaches to ethics and social responsibility	**Chapter 10**
E3	Professions and the public interest	**Chapter 10**
E4	Professional practice and codes of ethics	**Chapter 11**
E5	Conflicts of interest and the consequences of unethical behaviour	**Chapter 11**
E6	Ethical characteristics of professionalism	**Chapter 11**
E7	Social and environmental issues in the conduct of business and of ethical behaviour	**Chapter 12**

Learning Phases - Classroom tuition and Home study

Your studies for BPP consist of two elements, classroom tuition and home study.

Classroom tuition

In class we aim to cover the key areas of the syllabus. To ensure examination success you will to spend private study time reinforcing your classroom course with question practice and reviewing areas of the Course Notes and Study Text.

Home study

To support you with your private study BPP provides you with a Course Companion, which helps you to work at home, and aims to ensure your private study time is effectively used. The Course Companion includes a Home Study section, which breaks down your home study by days, one to be covered at the end of each day of the course. You will find clear guidance as to the time to spend on various activities and their importance.

You are also provided with progress tests and two course exams, which should be submitted for marking as they become due.

These may include questions on topics covered in class and home study.

BPP Learn Online

Come and visit the BPP Learn Online free at **www.bpp.com/acca/learnonline** for exam tips, FAQs and syllabus health check.

ACCA Forum

We have thriving ACCA bulletin boards at **www.bpp.com/accaforum**. Register and discuss your studies with tutors and students.

Helpline

If you have any queries during your private study simply contact your class tutor on the telephone number or e-mail address that they will supply. Alternatively, call +44 (0)20 8740 2222 (or your local training centre if outside the London area) and ask for a tutor for this paper to speak to you or to call you back within 24 hours.

Feedback

The success of BPP's courses has been built on what **you**, the students tell us. At the end of the course for each subject, you will be given a feedback form to complete and return.

If you have any issues or ideas before you are given the form to complete, please raise them with the course tutor or relevant head of centre.

If this is not possible, please email **ACCAcoursesfeedback@bpp.com**.

The scope of corporate governance

1

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Define and explain the meaning of corporate governance
- Analyse the purposes and objectives of corporate governance
- Explain, and apply in context of corporate governance, the key underpinning concepts of: fairness; openness/transparency; independence; probity/honesty; responsibility; accountability; reputation; judgment; and integrity
- Explain, and analyse the issues raised by, the development of the joint stock company as the dominant form of business organisation and the separation of ownership and control over business activity
- Define agency theory
- Define and explain the key concepts in agency theory: agents; principals; agency itself; agency costs; accountability; fiduciary responsibilities; and stakeholders
- Explain and explore the nature of the principal - agent relationship in the context of corporate governance
- Analyse and critically evaluate the nature of agency accountability in agency relationships
- Explain and analyse how transaction cost theory and stakeholder theory is used to explain aspects of the agency relationship
- Explain and assess the major areas of organisational life affected by issues in corporate governance.
- Compare and distinguish between public, private and non-governmental organisations (NGO) sectors, with regard to the issues raised by, and scope of governance
- Explain and evaluate the roles, interests and claims of internal parties involved in corporate governance.
- Explain and evaluate the roles, interests and claims of, the external parties wowed incorporate governance.
- Analyse and discuss the role, and influence of institutional investors in corporate governance systems and structures, for example the roves and influences of pension funds, insurance companies and mutual funds.

Exam Context

This chapter introduces the idea of agency theory and various models of stakeholder theory. In addition it covers the principals of corporate governance. These topics can be examined directly as in pilot paper question 3 and the examiner's question "Sentosa House" or they can be used as to provide a structure for a more general question as in examiner's question "JH Graphics". The principal of transparency was tested in a 10 mark compulsory question in the December 2007 exam. Accountability was also tested in December 2007 in section B.

Qualification Context

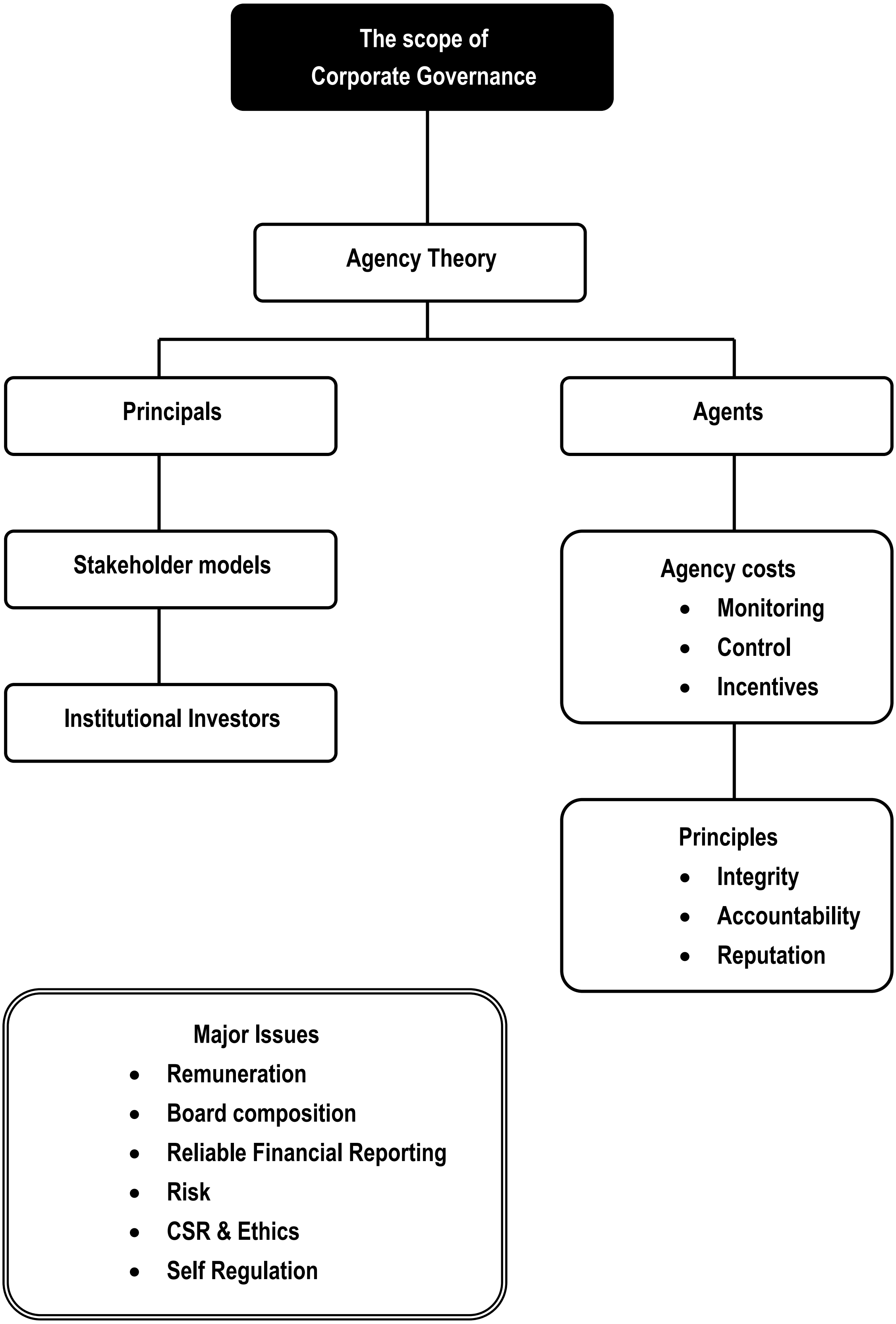
The idea of corporate governance is introduced in the law paper F4, which also introduces the separation of ownership and management. Agency theory and stakeholders are important ideas seen previously in F1, Accountant in Business and touched on in F3, Financial Accounting and F9, Financial Management.

Issues surrounding stakeholder are explored further in P3, Business Analysis and P4, Advanced Financial Management. Current issues in Corporate Governance, particularly as they affect audit firms, are examined in P7 Advanced Audit and Assurance.

Business Context

In recent years there have been widespread concerns over the failure of senior management to manage businesses in the best interest of their shareholders. The breakdown in this rather fundamental business relationship is has led to the development of comprehensive **corporate governance** guidelines, which under some jurisdictions are statutory.

Overview


The scope of
Corporate Governance
Agency Theory
Principals
Agents
Stakeholder models
Institutional Investors
Agency costs
• Monitoring
• Control
• Incentives
Principles
• Integrity
• Accountability
• Reputation
Major Issues
• Remuneration
• Board composition
• Reliable Financial Reporting
• Risk
• CSR & Ethics
• Self Regulation

1 Definition of corporate governance

1.1 Corporate governance can be defined as: **a set of relationships between a company's directors, its shareholders and other stakeholders. It also provides structure through which the objectives of the company are set, and the means of obtaining these objectives and monitoring performance are determined**.

1.2 It is a fundamental internal control system ensuring the best interests of the company are serviced in the most effective manner.

Lecture example 1

Classroom discussion

Required

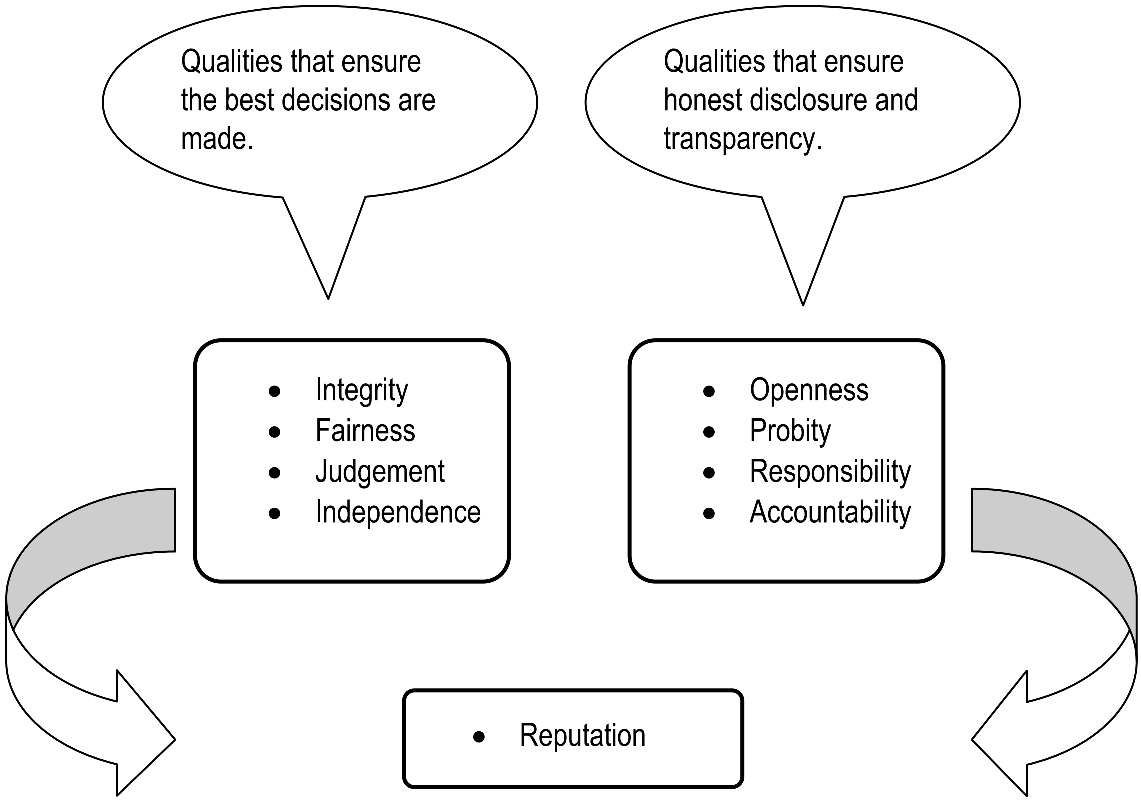
Suggest how a business could benefit from applying a framework for corporate governance.

Solution

1.3 For corporate governance to be effective it must be a feature of the inherent business culture, i.e. the way business is conducted.

1.4 In the exam you may need to ascertain whether or not the governance procedures in use in a particular company are in line with best practice.

1.5 The following diagram illustrates the core principles that underlie good corporate governance.



1.6 **Integrity**: Straightforward dealing and completeness; high moral character; honesty.

1.7 **Fairness**: Respecting the rights and views of any group with a legitimate interest.

1.8 **Judgement**: Making decisions that enhance the organisation's prosperity.

1.9 **Independence**: Having only limited or strictly controlled links to the organisation.

1.10 **Openness**: Disclosure, including voluntary disclosure of reliable information.

1.11 **Probity**: Truthful and not misleading.

1.12 **Responsibility**: Systematic correction of errors, failures or mismanagement.

1.13 **Accountability**: Answerable for the consequences of actions.

1.14 **Reputation**: Other people's perception or expectations. A valuable asset of the organisation.

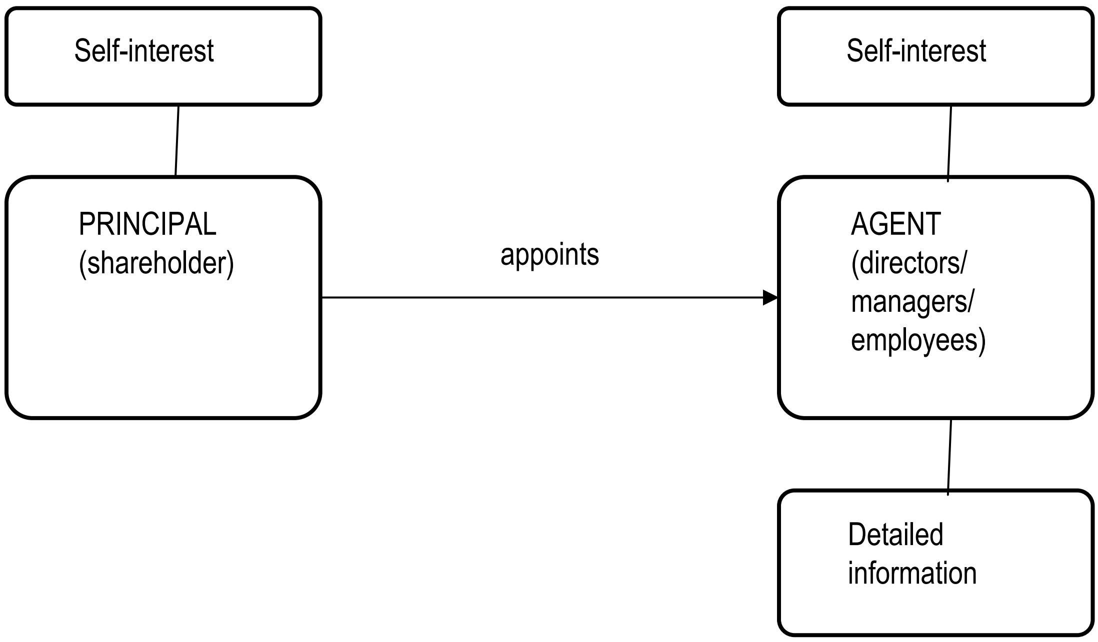
2 Corporate governance and agency theory

2.1 **Agency theory** is used to study the problems of motivation and control when a principal needs the help of an agent to carry out activities.

2.2 Agency theory would describe the shareholders in a company as the **principal,** with the board their **agents** who are empowered to act in their interests.

2.3 In practice the powers of shareholders tend to be very restricted. They normally have no right to inspect the books of account, and forecasts of future prospects are gleaned from the annual report and accounts, stockbrokers' reports, and media sources. There is an **information asymmetry**; the agent has more information than the principal.

The diagram below illustrates how agency works in practice .



The agency problem

2.4 Agency theory assumes that agent and principal act in their own self-interest. These interests may conflict.

2.5 The separation of ownership from management can cause issues if there is a breach of trust by directors either by intentional action, omission, neglect, or incompetence.

The agency solution

2.6 One power that shareholders possess is the right to remove the directors from office. But shareholders have to take the initiative to do this, and in many companies, the shareholders lack the energy and organisation to take such a step. Ultimately they can vote in favour of a takeover or removal of individual directors or entire boards, but this may be undesirable.

2.7 Shareholders can take steps to exercise control, but such action will be expensive, time consuming and difficult to manage because it is difficult to:

(a) Verify what the board is doing, partly because the board has access to more information about its activities than the principal does; and

(b) Introduce mechanisms to control the activities of the board, without preventing it from functioning effectively.

2.8 **Agency costs** arise when:

(a) The principals attempt to **monitor** the activities of agents. This may be viewed in monetary terms, resources consumed or time taken in monitoring.

(b) Establishing methods of **control**, such as directors' contracts of service and other **incentives**.

(c) Management spending non-productive time (and resources) proving that they are maximising shareholder value.

2.9 **Alignment of interests** is when the objectives of agents acting within an organisation are in accord with the objectives of the organisation as a whole.

Lecture example 2

Classroom discussion

Required

What control procedures and incentives could be employed to encourage alignment of interest between the company and its directors/senior management?

Solution

3 Transaction cost theory

3.1 Transaction cost theory provides an explanation of why organisations like companies exist, rather than all transactions being carried out between individual entrepreneurs.

3.2 Companies will try to keep as many transactions as possible in-house in order to;

(a) reduce uncertainties about dealing with suppliers,
(b) avoid high purchase prices, and
(c) manage quality.

3.3 In particular companies negotiate a few complex employment contracts, rather than negotiating a separate contract for each task they want an employee to undertake.

3.4 Employee's including directors/management behave rationally up to a point, but they are also opportunistic, organising their transactions in pursuance of their own interests. As employees, rather than self-employed entrepreneurs, they are more likely to shirk their duties.

3.5 This extends the idea of the agency problem. It explains why the agency problem is more severe the larger an organisation becomes.

4 Stakeholders in corporate governance

4.1 **Stakeholders** are people, groups or organisations that can affect or be affected by the actions or policies of an organisation. Each stakeholder group has different expectations about what it wants, and therefore different claims upon the organisation.

4.2 Stakeholders can be classified by their proximity to the organisation.

Stakeholder group	Members
Internal	Employees, management, the board
Connected	Shareholders, customers, suppliers, lenders, trade unions, competitors
External	The government, local government, the public, pressure groups, the media

4.3 Mendelow classifies stakeholders on a matrix [below] whose axes are power held and likelihood of showing an interest in the organisation's activities. These factors will help define the type of relationship the organisation should seek with its stakeholders, and how it should view their concerns.

Level of interest

Power	*Low*	*High*
Low	Minimal Effort	Keep Informed
High	Keep Satisfied	Key Players

4.4 Clearly, an organisation must keep its main stakeholder groups happy whether active or passive.

Stakeholder group	Members
Active	Those who seek to participate in the organisation's activities. This includes managers and some shareholders, but may also include other groups such as regulators and pressure groups.
Passive	Those who do not seek to participate in policy-making, such as most shareholders, local communities and government.

4.5 Passive stakeholders may still be interested and powerful. If corporate governance arrangements are to develop still further, there may be a need for powerful, passive stakeholders (eg **institutional investors**) to take a more active role.

Lecture example 3

Classroom discussion

Required

Who are the main stakeholder groups in a commercial company, and how should they be considered with respect to the role and scope of corporate governance?

Solution

Problems with stakeholder theory

4.6 A principle of company law in most jurisdictions remains the fiduciary and legal obligations that managers have to maximise shareholder wealth. Therefore, if managers are to fulfil responsibilities to a wider stakeholder base, it must not jeopardise long term profitability.

4.7 Some commentators have tried to reconcile stakeholder and agency theory by arguing that managers are stakeholders, responsible as agents to all other stakeholders. Although stakeholders have divergent interests that may be difficult to reconcile, this does not absolve management from at least trying to reconcile their interests.

4.8 There are two motivations for considering stakeholders. An **instrumental** view justifies considering stakeholders because of the economic benefits to the company. A **normative** view is based on the idea that the company has moral obligations towards stakeholders

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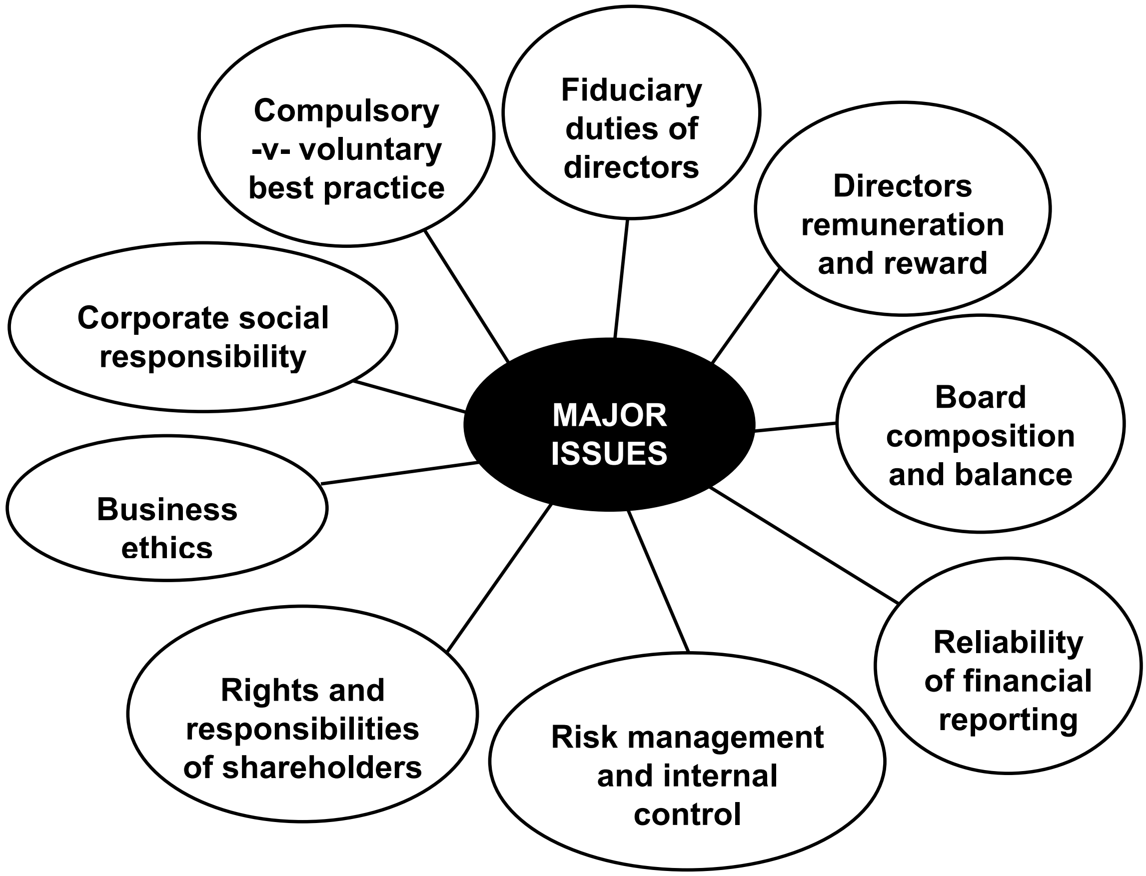
5 Major issues in corporate governance

5.1 The scope of corporate governance is vast and we shall expand on the following key issues during this course of study.

5.2 Major issues pertaining to corporate governance, that could arise in any exam question, are illustrated below.



6 Chapter summary

Section	Topic	Summary
1	Definitions and Fundamental Principles	Corporate Governance is concerned with the structures, processes and relationships that are fundamental to the company's objectives. Corporate Governance is built on the foundation of fundamental principles that seek to ensure good decision making, honest disclosure and reputation.
2	Agency Theory	Principals (shareholder) appoint agents (directors) to act on their behalf. The agency problem arises because of the agents' self-interest and information asymmetry, with the agent having more information than the principal. Agency costs are incurred in trying to align the interests of the agent with those of the principal. These are the costs of monitoring, controlling and incentivising the agents.
3	Transaction Cost Theory	Transaction Cost Theory extends agency theory to managers and employees.
4	Stakeholders	Stakeholders are any group that interacts with the company. They can be categorised as active or passive; internal, connected or external. Mendelow's grid is used to assess suitable responses: ignore, inform, satisfy or key player. Attitudes to stakeholders can be described as normative or instrumental.
5	Issues in Corporate Governance	Major issues have arisen out of corporate scandals. Try and keep an eye on emerging issues by reviewing quality newspapers or news websites.

END OF CHAPTER

Approaches to corporate governance

2

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Describe and compare the essentials of rules and principles-based approaches to corporate governance. Includes discussion of comply or explain
- Describe and critically evaluate the reasons behind the development and use of codes of practice in corporate governance (acknowledging national differences and convergence)
- Explain and briefly explore the development of corporate governance codes in principles-based jurisdictions (impetus and background, major corporate governance codes, effects)
- Explain and explore the Sarbanes-Oxley Act as an example of a rules-based approach to corporate governance (impetus and background, main provisions/contents, effects)
- Describe and explore the objectives, content and limitations of corporate governance codes intended to apply to multiple national jurisdictions (OECD, ICGN)
- Explain and explore social responsibility in the context of corporate governance
- Discuss and critically assess the concept of stakeholders and stakeholding in organisations and how this can affect strategy and corporate governance
- Analyse and evaluate issues of ownership, property and the responsibilities of ownership in the context of shareholding
- Explain the concept of the organisation as a corporate citizen of society with rights and responsibilities

Exam Context

This chapter provides a great deal of the core detail that underpins exactly how corporate governance is exercised in practice. Such an approach is critical when attempting questions enabling candidates can utilise the expanse of information contained within this chapter to generate ideas appropriate to the question set.

You may well have to discuss the implications of basing governance guidance on principles. The examiner has stated that knowledge of the main features and advantages and disadvantages of codes in general is important, but line-by-line knowledge isn't required. The existence of wider social responsibilities is likely to be a theme in many questions.

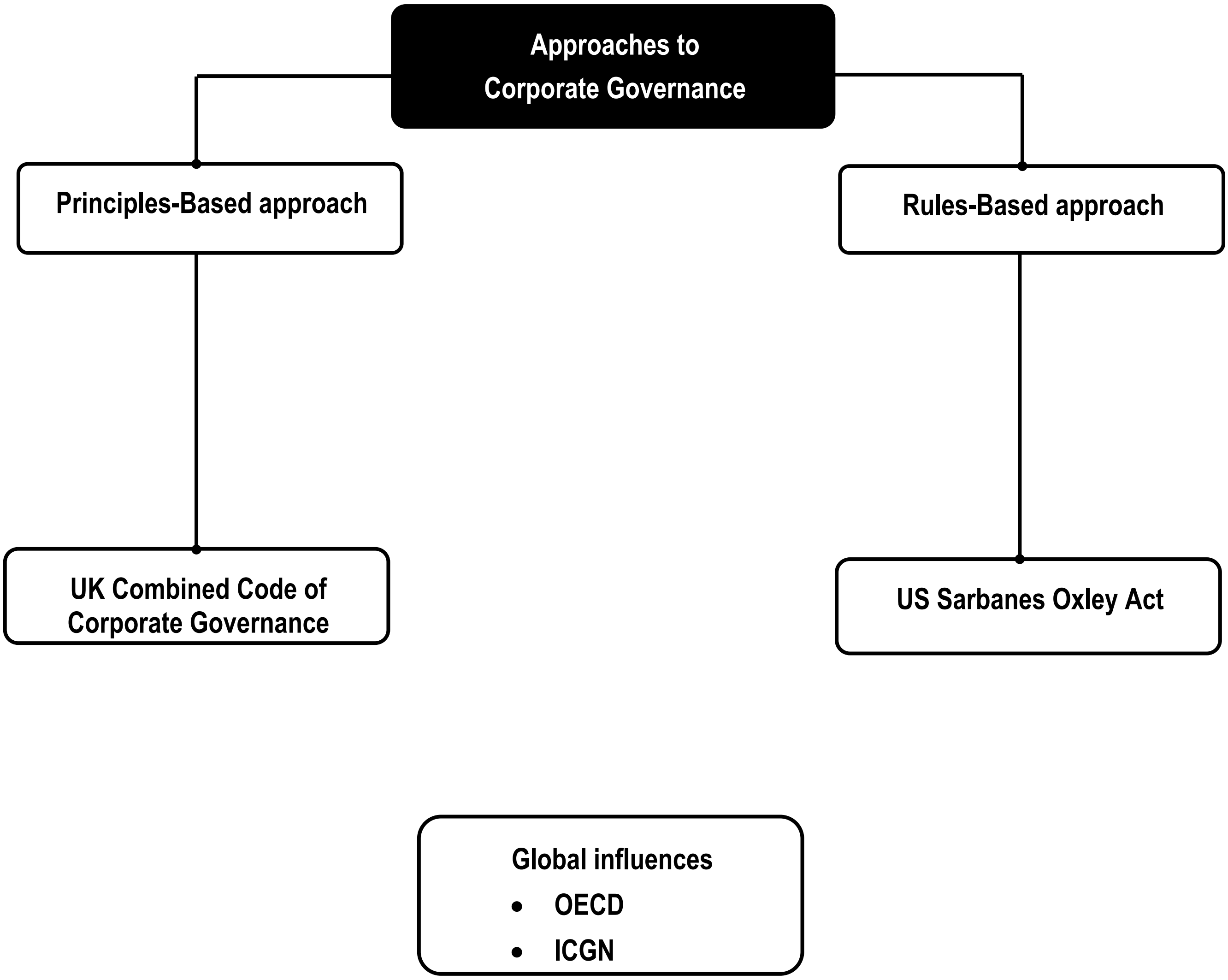
Qualification Context

The combined code is introduced in F8, Audit and Assurance. It is not explicitly examined but is an important example of a principles based approach.

Business Context

Appreciating the various approaches to corporate governance applied in different jurisdiction, clearly illustrates that there are several ways of dealing with this contentious area of business. In part the approach adopted will be symptomatic of cultural preferences and norms

Overview


Approaches to
Corporate Governance
Principles-Based approach
Rules-Based approach
UK Combined Code of Corporate Governance
US Sarbanes Oxley Act
Global influences
OECD
ICGN

1 Principles or rules?

1.1 The current big debate on corporate governance globally is whether the guidance should predominantly be in the form of principles, or whether there is a need for detailed rules and regulations.

	Principles-based approach	Rules-based approach
Features	Sets out broad principals (eg "The Board should be effective") supported by guidance. Works on a **comply or explain** basis, with any departure from the specific provisions of codes requiring an explanation Disclosure requirements means that a principles-based approach allows investors to decide if they agree that departure from the code is appropriate	Organisations are required to comply with a detailed and rigid code. Non-compliance cannot be justified. A company has either succeeded or failed in complying. Investors tend to rely on a third party (eg SFA) to penalise the company for non-compliance.
Benefits	Emphasises areas of corporate governance to which rules cannot easily be applied Applies across different legal jurisdictions, which makes the governance of a multi-national business more effective	Easier compliance with the rules, as they are unambiguous, and can be evidenced
Disadvantages	The principles, as set out in the Hampel report, are so broad that they are of very little use as a guide to best corporate governance practice.	Allows no leeway or deviation, irrespective of how illogical the situation is. Enforcement can be difficult for situations that are not covered explicitly in the rules.
Where you find them	Favoured in legal jurisdictions where the governing bodies of stock markets have had the prime role in setting standards for companies to follow.	Favoured in legal jurisdictions (and cultures) that lay great emphasis on obeying the letter of the law rather than the spirit of it.
Examples	UK-combined code 2006 (CC06)	USA– Sarbanes-Oxley Act 2002 (SOx)

Lecture example 1

Tutorial question

Required

What do you consider to be the main advantages of adopting a principles-based approach to corporate governance over a rules-based approach? [5 marks]

Solution

2 Influence of ownership on corporate governance

2.1 A key distinction that has been drawn between the corporate governance systems worldwide in different regimes has been between the **insider** and **outsider** models of ownership described below. In practice most regimes fall somewhere in between the two.

Insider systems

2.2 Insider (or relationship-based) systems are where most companies listed on the local stock exchange are owned and controlled by a small number of major shareholders. The shareholders may be members of the company's founding families, banks, other companies or the government.

2.3 The reason for the concentration of share ownership is the legal system.

Advantages	Disadvantages
It is easier to establish ties between owners and managers, therefore the agency problem is reduced.	There may be discrimination against minority shareholders.
It is easier to influence management, policy and strategy through dialogue.	Insider systems tend not to develop more formal governance structures until they are forced to.
A smaller base of shareholders may be more willing to take a long-term strategic view of their investment.	May be reluctant to employ outsiders in influential positions and recruit independent non-executive directors.
	More prone to opaque financial transactions and misuse of funds.
	Many large shareholders (particularly financial institutions) tend to avoid shares that are seen as speculative and invest only in 'blue chip' shares.

Outsider systems

2.4 Outsider systems are ones where shareholding is more widely dispersed, and there is the **manager-ownership separation**. Such shareholders can be drawn from varied and disparate sources and can have both small and large holdings.

2.5 There tends to be more diverse shareholder ownership in jurisdictions such as the UK that have strong protection for minority shareholders.

Advantages	Disadvantages
The separation of ownership and management has provided an impetus for the development of more robust legal and governance regimes to protect shareholders.	Companies are more likely to have an agency problem and significant agency costs.
Shareholders have voting rights that they can use to exercise control.	The larger shareholders in these regimes tend to have short-term priorities and prefer to sell their shares.
Hostile takeovers are far more frequent, and the threat of these acts as a disciplining mechanism on company management.	

2.6 British and American systems can both be classified as outsider systems.

Lecture example 2

Tutorial question

Required

What do you consider have been the significant factors that have influenced the development of corporate governance codes, rules and laws in recent years irrespective of the ownership system in operation? [5 marks]

Solution

3 Corporate governance development in the UK

Cadbury Report 1992

- Voluntary code of best practice
- Defined roles for all involved with financial statements
- Clear division of responsibilities
- Non-executive directors
- Audit committee

Greenbury Report 1995

- Determination of directors' pay
- Disclosure of directors' pay
- Remuneration committee

Hampel Report 1998

- Reduce regulatory burden
- Principles-based approach

Combined Code 1998

- Code of best practice derived from
  - Cadbury
  - Greenbury
  - Hampel

Turnbull Report 1998

- Risk management
- Internal control

Smith Report 2003

- Role of audit committees

Higgs Report 2003

- Role of non-executive directors

4 Corporate governance in other jurisdictions

King Report – South Africa

- Integrated approach to corporate governance
- Stakeholder interests and involvement central
- Social, environmental and economic aspects
- Regulatory disclosure

Singapore Code – 2001 and 2005

- Similar to UK Combined Code
- Describe governance practice
- Explain deviations

OECD

- Interest in governance arises from global investment issues
- Wide consultation with members
- Published principles of corporate governance
  - Rights of shareholders
  - Equitable treatment of shareholders
  - Role of stakeholders
  - Disclosure and transparency
  - Board responsibilities

International Corporate Governance Network (ICGN)

- Report published in 2005
- Practical guidance to companies
  - Board structure, membership and operation
  - Shareholders' rights and equitable treatment
  - Audit and accounts
  - Ethics and stakeholders, including corporate social responsibility
- Promotes communication between investors and companies to stimulate economic growth and success

Lecture example 3

Classroom dicsussion

Required

What do you consider to be the main problems with trying to establish international codes of corporate governance?

Solution

5 The Sarbanes-Oxley Act 2002

5.1 Sarbanes-Oxley (SOx) arose from the inadequacies in US corporate governance arrangements, shown by the Enron scandal.

5.2 SOx adopts a **rules-based approach** to governance.

5.3 Specific provisions of SOx legislation include:

The establishment of the Public Company Accounting Oversight Board
Auditors should review internal control systems
There should be rotation of lead or reviewing audit partners every five years
Auditors are expressly prohibited from carrying out most non-audit services
Audit committees should be responsible for the appointment, compensation and oversight of auditors.
All members of audit committees should be independent, and at least one member should be a financial expert.
Annual reports should contain internal control reports that state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and assess their effectiveness.
The chief executive officer and chief finance officer should certify the appropriateness of the financial statements.

5.4 The impact of SOx is widespread, illustrated in the table below:

US Domestic impact	International impact
For companies, fulfilling the requirement to ensure their internal controls are properly documented and tested	Around 1,500 non-US companies list their shares in the US. They are covered by the provisions of SOx
For accountancy firms, SOx has formally stripped them of almost all non-audit revenue streams that they used to derive from their audit clients	The US being such a significant influence worldwide, SOx is likely to persuade other countries to adopt a rules-based approach to corporate governance
For lawyers, SOx requires them to whistle blow on any wrong doing they uncover at client companies, right up to board level	

5.5 There are a number of criticisms of SOx, including:

(a) It is not strong enough on some issues, and at the same time over-rigid on others.

(b) Directors may be less likely to consult lawyers if they believe that SOx could override lawyer-client privilege.

(c) A SOx compliance industry has sprung up.

(d) Companies are turning away from the US stock markets and towards other markets, such as London.

6 Chapter summary

Section	Topic	Summary
1	Principles or Rules	Principals based practice outlines core principals to ensure good corporate guidance. Departures from best practice have to be disclosed ('comply or explain') and investors then take appropriate action. The advantages of principals are; flexibility, adaptability, avoids 'loopholes'. Rules based practice requires compliance with a detailed code. Compliance in full is mandatory. Non-compliance is penalised often by a regulator. The advantages of rules are; unambiguous, easier to monitor.
2	Ownership	Insider organisations (eg family firms) have reduced agency costs and often arise in jurisdictions with weak minority interest protection. Outsider organisations dominate in the US and UK and are characterised by many small investors and institutional investors.
3	Corporate Governance in the UK	The Combined Code (CC06) covers directors, remuneration, accounting and controls, auditors and institutional investors. It is supported by guidance (such as the Turnbull Report). Corporate Governance emerged as an issue in the early 1990's following corporate failures such as Polly Peck and Mirror Group (unfettered power of dominant directors) and later Barings Bank (poor internal controls).
4	Corporate Governance Globally	The South African King Report was published after the collapse of apartheid. It emphasises fairness to all groups in society and economic wellbeing, The OECD and ICGN both issue guidance which is useful where no local code is available.
5	Corporate Governance in the US – Sarbanes Oxley (SOx)	The Sarbanes Oxley Act is the US rules based code enacted after the collapse of Enron and WorldCom. Its main provisions cover the audit profession, audit committees, internal controls, CEO and CFO responsibility for financial statements, plus many detailed provisions such as full disclosure of off-balance sheet finance. Sarbanes Oxley affects all companies listed on US stock exchanges and their subsidiaries.

END OF CHAPTER

Corporate governance practice and reporting

3

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain and evaluate the roles and responsibilities of boards of directors
- Describe, distinguish between and evaluate the cases for and against unitary and two-tier structures
- Describe the characteristics, board composition and types of directors (including defining executive and non-executive directors)
- Describe and assess the purposes, roles and responsibilities of non-executive directors
- Describe and analyse the general principles of the legal and regulatory frameworks within which directors operate on corporate boards
- Define, explore and compare the roles of the chief executive and company chairman
- Describe and assess the importance, and execution, of induction and continuing professional development of directors on boards of directors
- Explain and analyse the frameworks for assessing the performance of boards and individual directors (including NEDs) on boards
- Explain and assess the importance, roles and accountabilities of board committees in corporate governance
- Explain and evaluate the role and purpose of the following committees in effective corporate governance: remuneration committee, nominations committee, risk committee
- Describe and assess the general principles of remuneration
- Explain and assess the effect of various components of remuneration packages on directors' behaviour
- Explain and analyse the legal, ethical, competitive and regulatory issues associated with directors' remuneration
- Explain and assess the general principles of disclosure and communication with shareholder
- Explain and analyse best practice corporate governance disclosure requirements, for example under the UK Combined Codes
- Define and distinguish between mandatory and voluntary disclosure of corporate information in the normal reporting cycle
- Explain and explore the nature of, and reasons and motivations for, voluntary disclosure in a principles-based reporting environment (compared with for example, the reporting regime in the USA)
- Explain and analyse the purposes of the annual general meeting and extraordinary general meetings for information exchange between the board and shareholders
- Describe and assess the role of proxy voting in corporate governance

Exam Context

Two different aspects of this chapter appeared as knowledge-based questions in the Pilot paper. Therefore, it is quite apparent that a detailed knowledge of how boards are 'supposed to function' together with governance disclosures and reporting is key to success in the exam.

Qualification Context

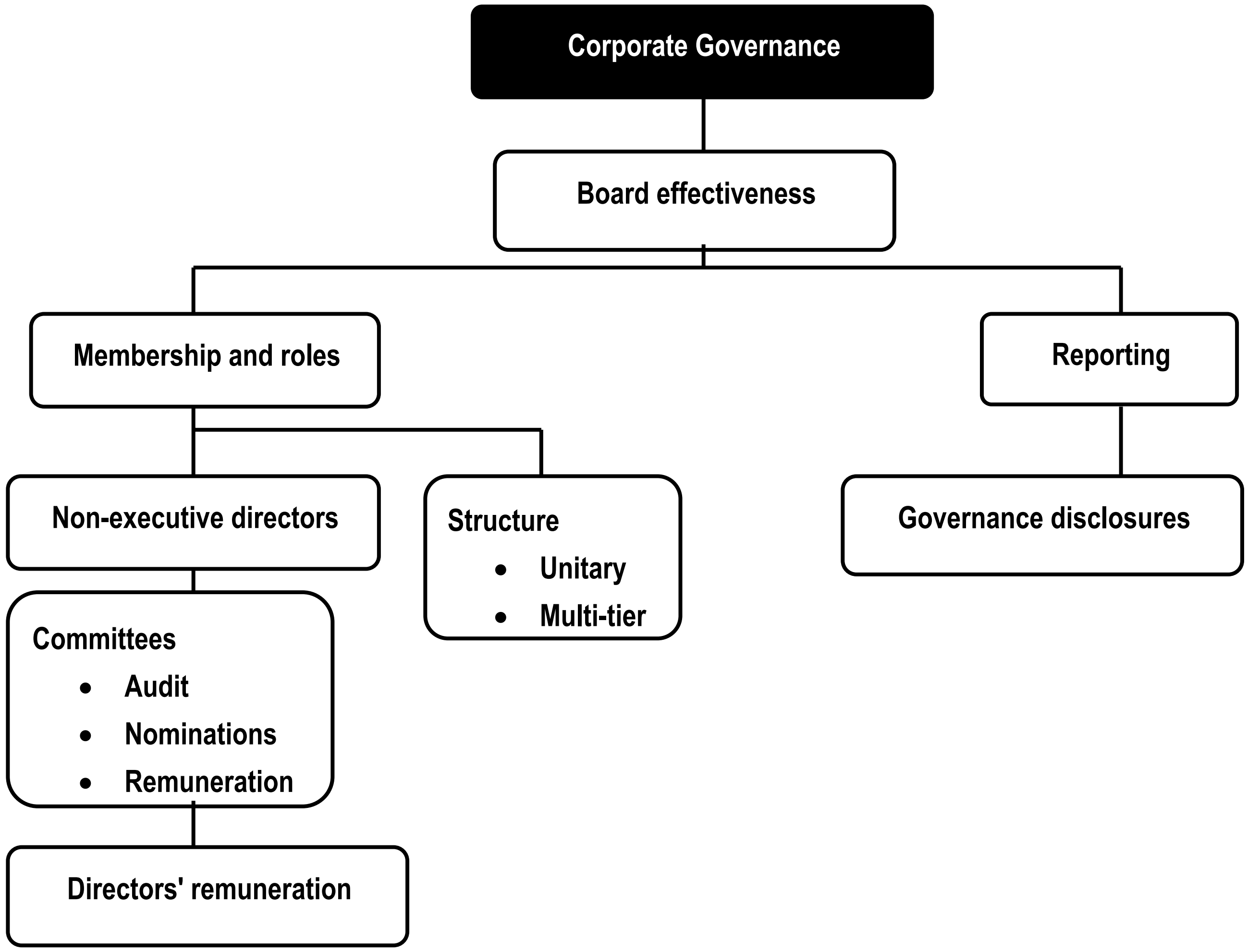
F1, Accountant in practice introduced ideas, in particular about leadership and motivation, which provide a good introduction to the issues covered by this chapter. Many jurisdictions have a legal framework for the roles and responsibilities of directors and this is covered in F4, Corporate and Business Law. Your studies in Financial Accounting and Financial Reporting will have made you aware of much of the disclosure needed by companies.

If you are studying or have studied P3, Business Analysis you will find your studies of reward management useful.

Business Context

This is very much a developing area of business practice. Acknowledging that without complete, transparent and relevant disclosure of governance practice, the public confidence it is trying to promote will not be attained.

Overview


Corporate Governance
Board effectiveness
Membership and roles
Reporting
Non-executive directors
Structure
• Unitary
• Multi-tier
Governance disclosures
Committees
• Audit
• Nominations
• Remuneration
Directors' remuneration

1 The role of the board

1.1 The board

(a) Is collectively responsible for promoting the success of the company by directing and supervising the company's affairs.

(b) Provides entrepreneurial leadership of the company, within a framework of prudent and effective controls, which enable risk to be assessed and managed.

(c) Should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance.

Lecture example 1

Classroom discussion

Required

What additional tasks should form part of the board's role?

Solution

2 Effectiveness of boards

2.1 To remain effective, directors should extend their knowledge and skills continuously.

2.2 Significant issues that professional development should cover on a regular basis include:

2.3 An appraisal of the board's performance is an important control over it, aimed at improving board effectiveness, maximising strengths and tackling weaknesses. It should be seen as an essential part of the feedback process within the company and may prompt the board to change its methods and/or objectives.

Lecture example 2

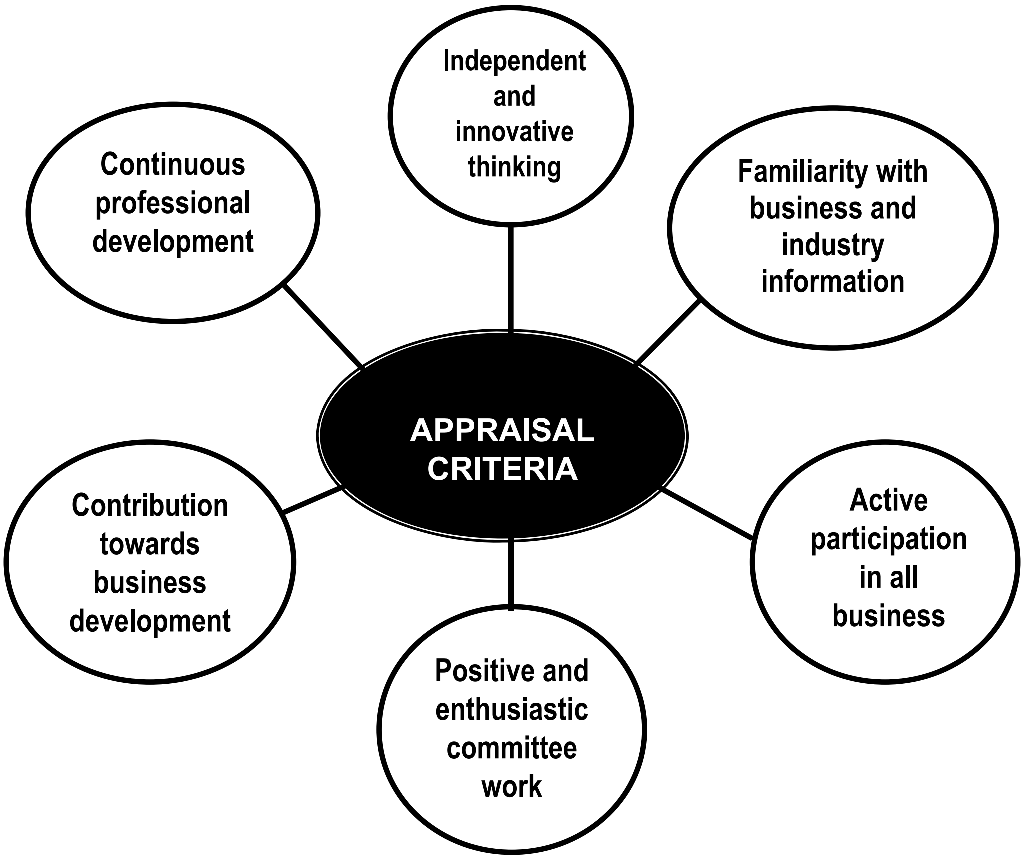
Exam standard question

Required

Suggest a range of criteria upon which the effectiveness of a board could be accurately and holistically appraised. [8 marks]

Solution

2.4 All directors should be individually appraised; criteria that could be applied include:



3 Board membership and roles

3.1 Key issues for consideration for board membership are:

(a) **Size** – the balance needs to be struck between the benefits of having varied views and opinions, alongside the need for coherence of decision-making.

(b) **Inside/outside mix** – the split between executive decision-making directors and non-executive directors. Independent non-executive directors have a key role in governance. Their number and status should mean that their views carry significant weight.

(c) **Diversity** mix in terms of gender, ethnicity, backgrounds, experience, etc.

3.2 Division of responsibilities at the head of an organisation is most simply achieved by separating the roles of chairman and chief executive

Responsibilities of the chairman of the board	Responsibilities of the chief executive officer
Provide leadership to the board, ensuring its effectiveness & setting its agenda	Provide leadership to the business, ensuring the effectiveness of business operations and setting strategy
Ensuring the board receives accurate and timely information	Providing accurate & timely information
Ensuring effective communication with shareholders and that their views are communicated to the board as a whole.	Communicating effectively with significant stakeholders
Facilitate effective contribution from NEDS, ensure constructive relations between execs and NEDs	Facilitate the effective implementation of board decisions.
Take the lead in providing an induction programme for new directors and in board development	Cooperate in induction and development.
Meet with the NEDs without the executives present	Cooperate by providing any necessary resources.
Facilitating board appraisal	Cooperate in board appraisal.
Encouraging active engagement by all the members of the board	Cooperate with all the members of the board.

Lecture example 3

Classroom discussion

Required

Suggest reasons why the roles of chairman and CEO should be held by two different people.

Solution

3.3 Many companies operate a series of board sub-committees responsible for supervising specific aspects of governance. The main board committees are:

Audit Committee is responsible for liaising with external audit, supervising internal audit and reviewing the annual accounts and internal controls. (see chapter 5)

Remuneration Committee is responsible for advising on executive director remuneration policy and the specific package for each director.

Nominations Committee is responsible for recommending the appointments of new directors to the board.

Risk Committee is responsible for overseeing risk management.

4 Non-executive directors

4.1 Non-executive directors (NEDs) have no executive (managerial) responsibilities.

4.2 NEDs have a key role in reducing conflicts of interest between management (including executive directors) and shareholders.

4.3 The role of non-executive directors includes:

(a) **Strategy.** contributing to, and challenging the direction of, strategy.

(b) **Scrutiny**. NEDs should scrutinise the performance of management in meeting goals and objectives, monitor the reporting of performance. They should represent the shareholders' interests to ensure agency issues don't arise to reduce shareholder value. (See Chapter 1)

(c) **Risk**. NEDs should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust.

(d) **People**. NEDs are responsible for determining appropriate levels of remuneration for executives, and are key figures in the appointment and removal of senior managers and in succession planning.

Advantages of NEDs	Problems with NEDs
May have a range of external experience and knowledge that executive directors do not possess.	Lack of independence, if they are recruited by executive directors
Provide a broader perspective on issues as they are not involved in detailed operations.	Lack of authority imposing their views upon the board
Offer assurance for third parties such as investors or creditors	They are often confined to merely to representing stakeholder interests
Are full board members who hold full voting rights	Limited time that they can devote to the role
Provide the strong, independent element on the board	High-calibre NEDs may be attracted to the best-run companies, rather than those in most in need of them
Have detachment, which enables them to monitor the company's affairs effectively	
It is compliant with corporate governance codes (e.g. CC06)	

Lecture example 4 — Classroom discussion

Required

What safeguards could be put in place to ensure the independence of NEDs?

Solution

5 Unitary and Multi-tier boards

5.1 The single board structure with sub-committees is known as a **unitary** structure

Advantages of unitary structure	Disadvantages of a unitary structure
All participants have equal legal responsibility for management of the company and strategic performance	A NED or independent director cannot be expected to both manage and monitor
A single board promotes easier co-operation and co-ordination	The time requirements on non-executive directors may be onerous
The presence of NEDs should lead to better decisions being made	There is no specific provision for employees to be represented on the management board
Independent NEDs are less likely to be excluded from decision-making and given restricted access to information	Emphasises the divide between the shareholders and the directors

5.2 In some countries the board is split into **multi-tiers**, separating the executive from other directors (and senior management). This structure is also common in not-for-profit organisations such as schools.

5.3 This multi tier approach can take the form of a:

(a) **Supervisory board** with no executive function. It reviews the company's direction and strategy, and is responsible for safeguarding stakeholders' interests.

(b) **Management or executive board** composed entirely of executive directors/managers. It is responsible for the running of the business. The supervisory board appoints the management board.

Lecture example 5

Exam standard question

Required

What do you consider to be the advantages and disadvantages of operating a multi-tier board structure? [8 marks]

Solution

6 Directors' remuneration

6.1 The purpose of directors' remuneration is to be sufficient to:

(a) Attract and retain individuals of sufficient calibre, and

(b) Motivate them to achieve performance levels that are in the shareholders' best interests as well as their own personal interests.

6.2 The Remuneration Committee determines the organisation's general policy on the remuneration of executive directors, which according to the combined code should involve:

(a) A significant proportion of rewards being related to measurable business performance or enhanced shareholder value.

(b) Full transparency of directors' remuneration in the annual accounts.

(c) Taking account of the position of the company relative to other similar companies. However the combined code also notes "the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance" and the need to be sensitive lo pay conditions within the company.

Lecture example 6

Classroom discussion

Required

Describe what features could be included in a directors' remuneration, and suggest why these might be attractive.

Solution

6.3 In order for the financial statements to present an accurate picture of remuneration arrangements, the annual report would need to disclose:

(a) Remuneration policy

(b) Detailed arrangements for individual directors

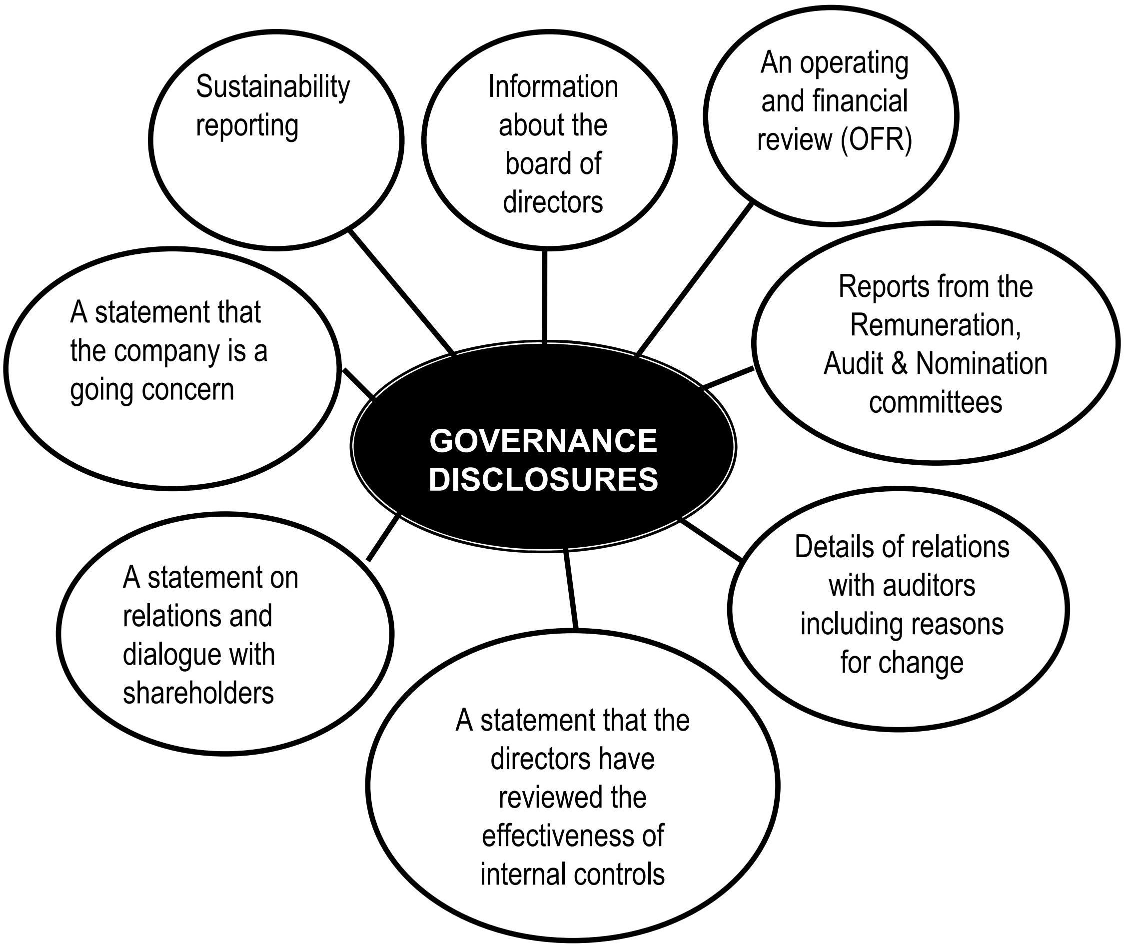
(c) Performance conditions attached to remuneration packages

(d) The duration of contracts with directors, and notice periods and termination payments under such contracts.

7 Governance disclosures

7.1 Annual reports should disclose whether the organisation has complied with governance regulations and codes.

7.2 Governance disclosures should include:



8 Chapter summary

Section	Topic	Summary
1	The role of the board	The board act as agents for the shareholders. They provide leadership and establish strategies to ensure that the company achieves its objectives.
2	Effectiveness of boards	The first principle in CC06 is that the board should be effective. This requires training and development of board members and appraisal of the performance of the whole board and of individual members.
3	Board membership and roles	The board should be balanced. The Chairman of the board runs the board and the CEO who should be a different person runs the company.
4	Non-executive directors	NEDs are not involved in the day to day running of the company. Ideally they should be independent. They have four main roles; scrutinising the decisions and disclosures of the board; advising objectively on strategy, risk and people (remuneration and nominations).
5	Unitary and multi-tier boards	A single board can speed up decision making and ensure uniformity of authority and responsibility. Multi-tier boards are common in continental Europe and are a good way of widening participation in strategic decisions. The supervisory board often includes employee or union representatives.
6	Directors remuneration	Basic salary, benefits and pensions are not related to performance and should be sufficient to recruit and retain the right people. Performance Related Remuneration should be designed to align the director's interests to the objectives of the company. They can relate to KPIs. Shares and share options should not be used to remunerate NEDs but can help align the executives' interests with the long term objectives of the company.
7	Governance disclosures	The disclosure required will depend on the corporate governance regime. In a principals based regime the disclosure should be adequate to allow the investors to make informed decisions about corporate governance. (Comply or explain).

END OF CHAPTER

Internal control systems

4

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Define and explain internal management control
- Explain and explore the importance of internal control and risk management in corporate governance
- Describe the objectives of internal control systems
- Identify and assess the importance of elements or components of internal control systems
- Explore and evaluate the effectiveness of internal control systems

Exam Context

You may be asked to provide an appropriate internal control framework for an organisation, or to assess a framework that is described in a scenario. Look out in particular for whether the underlying control environment appears to be sound. An organisation with a poor control environment featured in one of the pilot paper questions.

Qualification Context

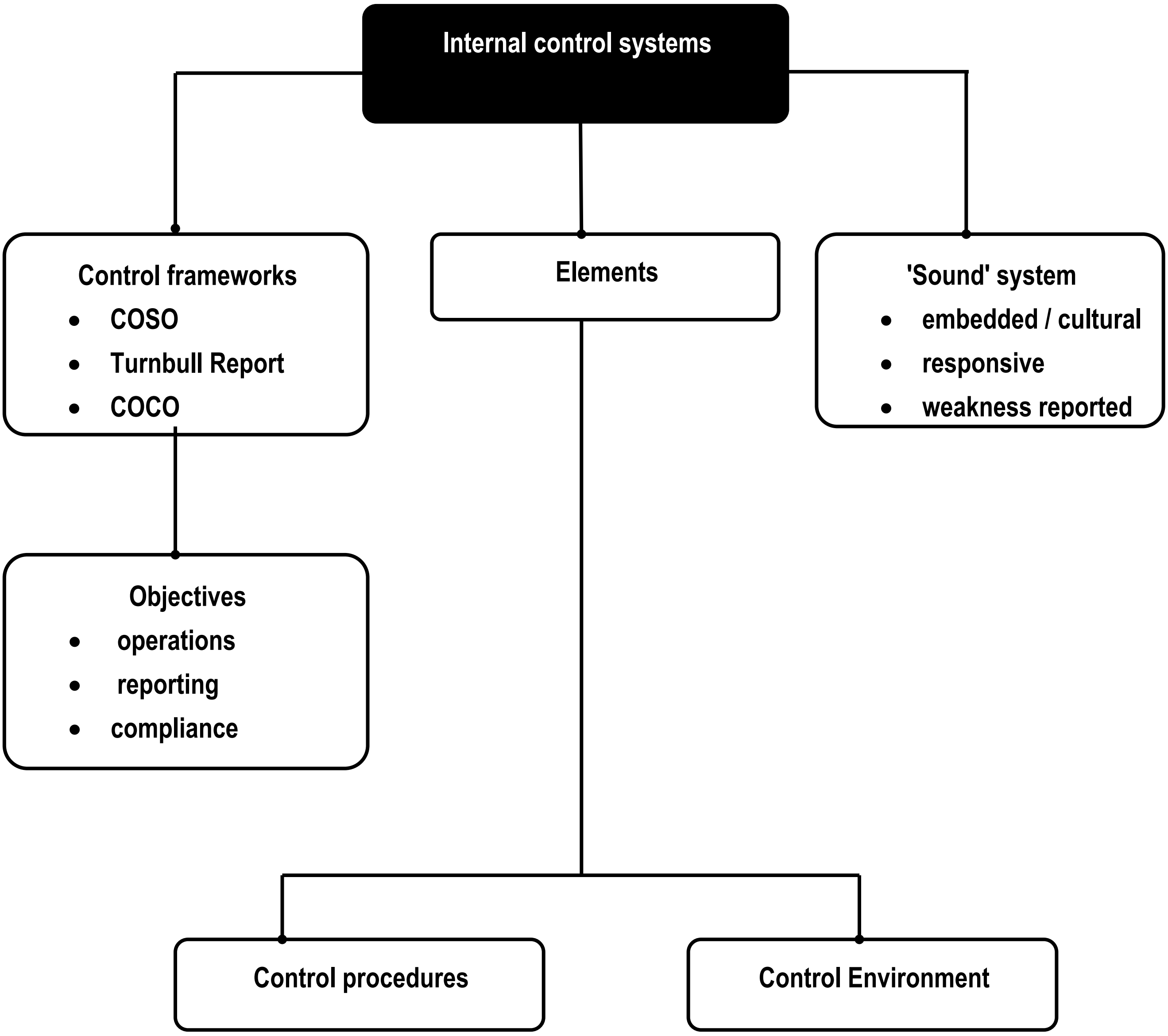
Internal control Systems are examined in F8, Audit and Assurance. When considering the people operating the controls you could consider issues of recruitment studied in F1, Accountant in Business.

Business Context

For a business to remain successful it must develop and maintain a robust system on internal control. Only then can the board have reasonable assurance that they are operating efficiently and effectively and are likely to deliver their strategic objectives.

Weak internal controls are often cited the precursor to corporate collapse. This emphasises the importance of feedback and continuous improvement in control systems, and is something worth looking for in exam scenarios – does the organisation appear capable of making essential improvements?

Overview


Internal control systems
Control frameworks
COSO
Turnbull Report
COCO
Elements
'Sound' system
embedded / cultural
responsive
weakness reported
Objectives
operations
reporting
compliance
Control procedures
Control Environment

1 Internal control systems

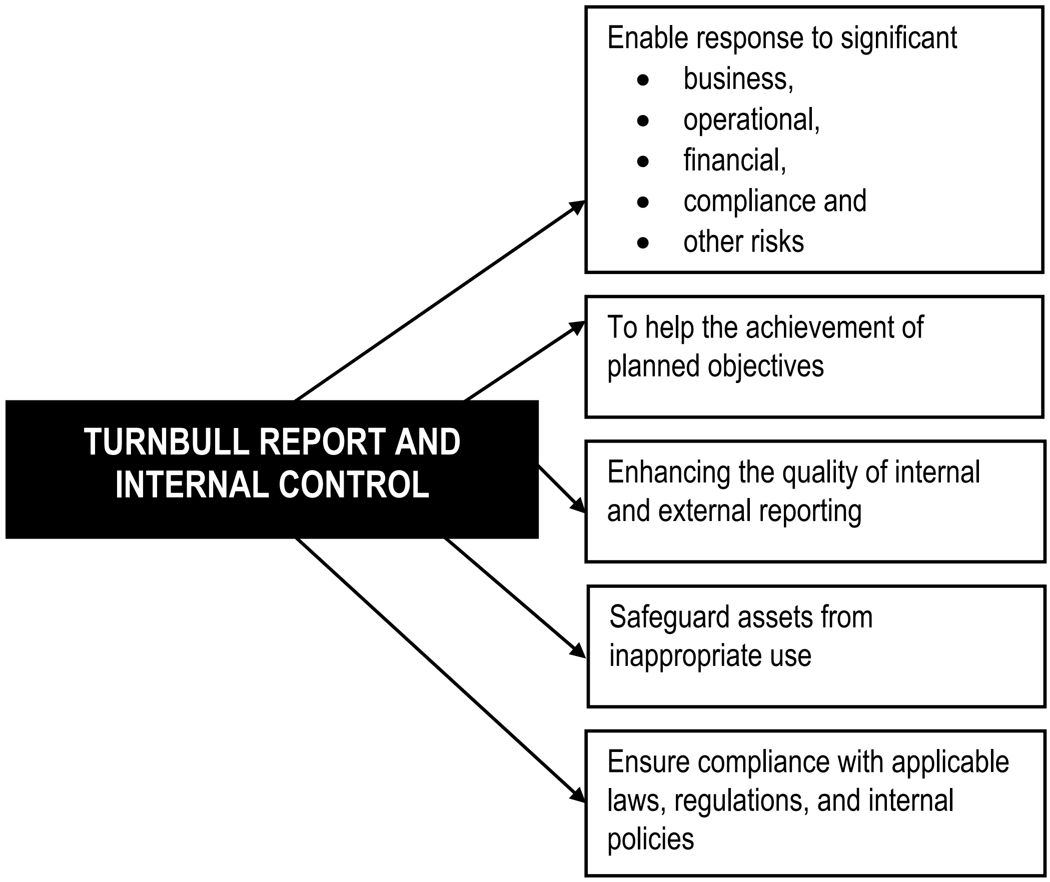
1.1 **Control** can be described as ensuring what the organisation intends to happen, happens in the way it's suppose to happen, when it's supposed to happen.

1.2 Control arises through a combination:

(a) Effective and coherent business planning;
(b) Suitable organisational structure; and
(c) Clear management direction.

1.3 **Internal control** is any action taken by management to enhance the likelihood that established objectives and goals will be achieved.

1.4 The UK Turnbull Report summarises of the main purposes of an internal control system.



2 Internal control frameworks

2.1 Internal control frameworks include:

(a) **Control environment** – the overall context of control, in particular the attitude of directors and managers towards control (cultural dimension)

(b) **Control procedures** – the detailed controls established and operated

COSO

2.2 The Committee of Sponsoring Organisations (COSO) of the Treadway Commission devised an internationally recognised control framework. COSO is the main source of guidance in the US.

2.3 It identifies three broad areas in which controls must operate to ensure risks are managed and objectives achieved.

Efficient and effective business operations

Compliance

Reporting

COCO

2.4 The criteria of control (COCO) framework, stresses the need for all aspects of activities to be clearly directed with a sense of purpose.

2.5 This includes overall objectives, mission and strategy; management of risk and opportunities; policies; plans and performance measures.

2.6 The COCO framework suggests the following are pre-requisite for an effective control framework

Resources and competences to operate the control systems

Deal with problems and take appropriate corrective actions

COCO

Management identify themselves with the organisation and its values

Monitoring and learning

Lecture example 1

Classroom discussion

Required

What do you consider could be the inherent weaknesses or limitations of internal control frameworks?

Solution

3 The control environment and control procedures

3.1 Effective internal control can only be delivered if there is:

(a) A suitable control environment for the organisation and its staff to operate within; and

(b) Appropriate control procedures designed to manage business activities within the firm's competitive environment

Control Environment	**Control Procedures**
The following factors constitute the **control environment**. (a) Corporate culture (b) Management style (c) Organisational structure (d) Methods of imposing control (e) Ethical values	Internal **controls procedures** can be classified as: (a) Corporate controls (e.g. general policy statements, the established core culture and overall monitoring procedures) (b) Management controls encompassing planning and performance monitoring (c) Business process controls (e.g. authorisation limits and reconciliation) (d) Transaction controls include (e.g. accuracy and completeness checks)
The Turnbull Report highlighted the following as elements of a strong control environment: (a) Senior management commitment (b) Clear strategy (c) Strong business culture (d) Clear definition of authority, responsibility and accountability (e) Effective internal communication adequate knowledge, skills and resources	**The Turnbull Report** suggests that internal control procedures should: (a) Be embedded in the operations of the company (b) Form part of its 'culture' (i.e. the way things are done around here) (c) Be capable of responding quickly to evolving risks within the business (i.e. be adaptive and flexible) (d) Include procedures for reporting immediately to management significant control weaknesses, together with control action taken to remedy the situation

4 General and administrative controls

4.1 The UK Auditing Practices Board's SAS 300 [*Accounting and internal control systems and risk assessments]* lists some specific control procedures:

(a) Approval and control of documents
(b) Controls over computerised applications and the information technology environment
(c) Checking the arithmetical accuracy of the records
(d) Maintaining and reviewing control accounts and trial balances
(e) Reconciliations
(f) Comparing the results of cash, security and stock counts with accounting records
(g) Comparing internal data with external sources of information
(h) Limiting direct physical access to assets and records

4.2 An easy way to generate ideas is to use the mnemonic **SPAMSOAP**

Segregation of duties, with no one person having total control of an area.

eg the chairman/CEO roles should be split (Cadbury)

Physical measures to secure the custody of assets

eg access control to buildings

Authorisation and approval of all business activities by appropriate persons

eg non-executive directors to decide directors' pay staff a remuneration committee

Management should provide control through analysis and review of accounts

eg tasking internal audit

Supervision of the recording and operations of day-to-day transactions

eg budget monitoring through exception or variance reports

Organisation identify reporting lines, levels of authority and responsibility. This ensures everyone is aware of their control (and other) responsibilities, especially in ensuring adherence to management policies

eg enabling named staff to act independently within areas of delegated power

Arithmetical and accounting to check the correct and accurate recording and processing of transactions

eg bank account reconciliation

Personnel Attention should be given to selection, training and qualifications of personnel, as well as personal qualities

eg checking reference during a recruitment process

5 Internal controls and risk management

5.1 An organisation's internal controls should be designed to counter the **risks** that are a consequence of the objectives it pursues.

5.2 The UK Turnbull Report stresses the links between internal controls and risk very strongly.

5.3 Turnbull states that in order to determine its policies in relation to internal control and decide what constitutes a sound system of internal control, the board should consider:

(a) The nature and extent of risks facing the company

(b) The extent and categories of risk which it regards as acceptable for the company to bear

(c) The likelihood of the risks concerned materialising

(d) The company's ability to reduce the incidence and impact on the business of risks that do materialise

(e) The costs of operating particular controls relative to the benefit obtained in managing the related risks

6 Chapter summary

Section	Topic	Summary
1	Internal Control Systems	The five main purposes of internal control systems are to help a company: achieve objectives efficiently and effectively; respond to risk; ensure the quality of reporting; ensure compliance; and safeguard assets.
2	Internal Control Frameworks	Internal control frameworks cover the control environment and control procedures. Two key frameworks are COSO a US framework and the Turnbull Guidance which supports the UK's CC06
3	The Control Environment and Control Procedures	The control environment is dependent on corporate culture, management styles, organisational structures, and ethical values. Control Procedures can be classified according to level from corporate controls (eg policies), management controls (eg budgets, business process controls (eg authorisation limits) down to transaction controls (eg arithmetic checks)
4	General and Administrative Controls	SPAMSOAP
5	Internal Controls and Risk Management	Internal controls should be designed around the risk faced by the company. The costs and benefits of controls should also be considered.

END OF CHAPTER

Internal audit

5

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Describe the function and importance of internal audit
- Explain, and discuss the importance of, auditor independence in all client audit situations (including internal audit)
- Explain, and assess the nature and sources of risks, to auditor independence. Assess the hazard of auditor capture
- Explain and evaluate the importance of compliance and the role of the internal audit committee in internal control
- Describe and analyse the work of the internal audit committee in overseeing the internal audit function
- Explain, and explore the importance and characteristics of, the audit committee's relationship with external auditors
- Describe and assess the role of internal or external risk auditing in monitoring risk

Exam Context

Scenarios where internal audit independence is threatened are likely to be set in the exam, and you may also have to judge, based on the detail you're given, how effective a particular internal audit function is. Any or all aspects of an internal audit committee's work may be set in the exam.

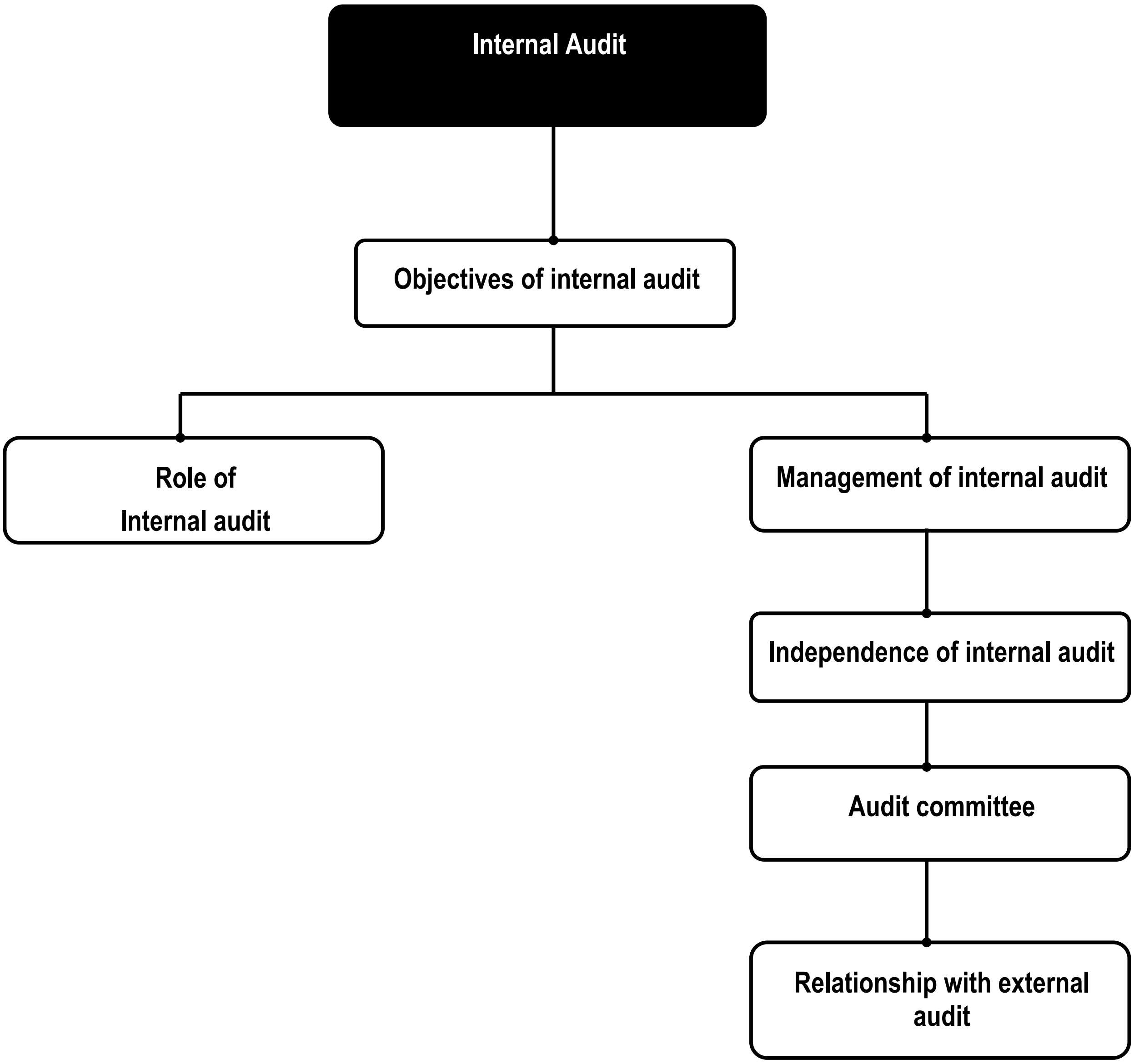
Qualification Context

Internal Audit is studied in detail in F8, Audit and Assurance and again in P7, Advanced Audit and Assurance.

Business Context

Many of the reports relating to corporate governance stress the importance of having an effective internal audit function to control and manage business functions and risks. In some jurisdictions (e.g. New York Stock Exchange listing) it is a mandatory requirement.

Overview


Internal Audit
Objectives of internal audit
Role of
Internal audit
Management of internal audit
Independence of internal audit
Audit committee
Relationship with external
audit

1 The role of internal audit

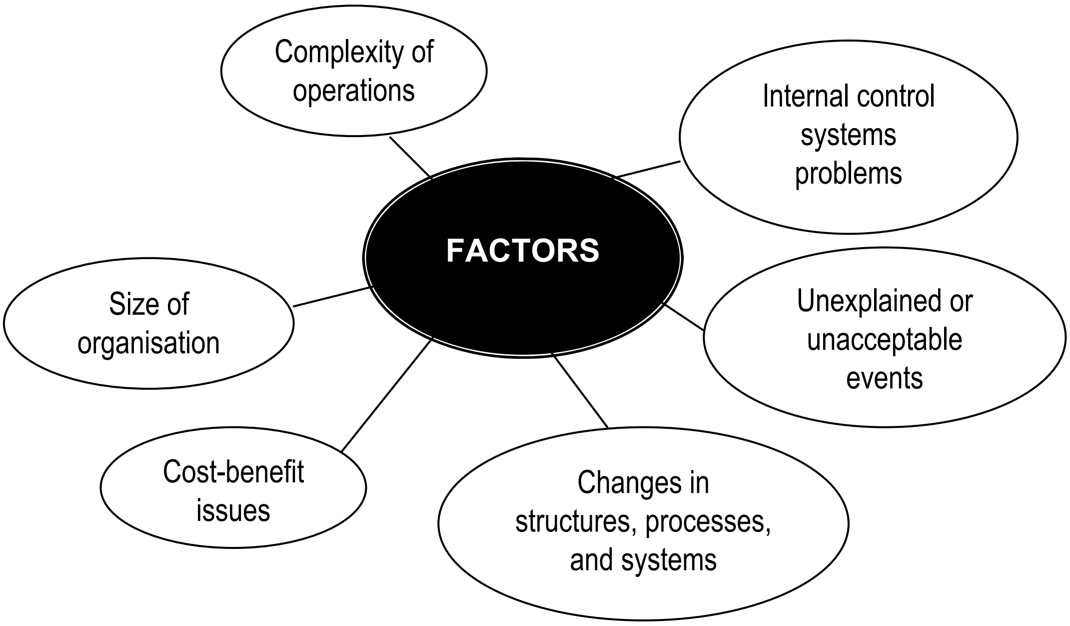
1.1 Internal audit is defined as **'an appraisal or monitoring activity established by management and directors for the review of the accounting and internal control systems as a service to the entity. It functions by, amongst other things, examining, evaluating and reporting to management and the directors on the adequacy and effectiveness of components of the accounting and internal control systems'**.

(UK Auditing Practices Board)

1.2 The role of internal audit will vary according to the organisation's objectives, but is likely to include:

(a) Review of internal control systems;
(b) Risk management;
(c) Legal compliance; and
(d) Value for money assessment

1.3 Not all organisations have an internal audit function. Companies without internal auditors need to carry out an annual review to determine if they need to establish internal audit. The factors to consider are:



2 Objectives of internal audit

2.1 Internal audit has a significant role to play in the organisation's risk management processes, in terms of:

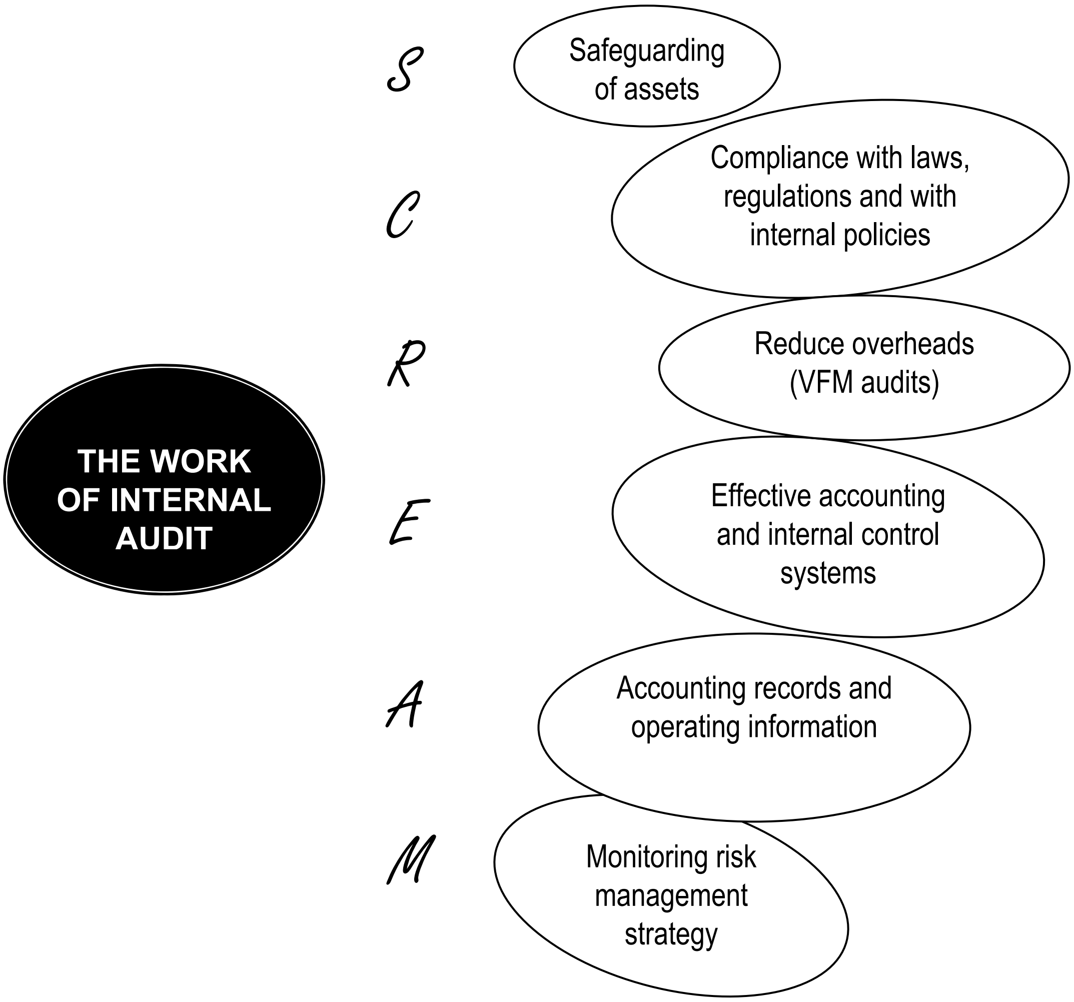
(a) The adequacy of the risk management and response processes for identifying, assessing, managing and reporting on risk

(b) The risk management and control culture

(c) The internal controls in operation to limit risks

(d) The operation and effectiveness of the risk management processes

2.2 The work of the internal audit extends beyond risk management; it can cover the following broad areas.



3 Independence of internal audit

3.1 For internal audit to be effective in performing its role, it should:

(a) Be independent

(b) Be objective in performing their work

(c) Have an impartial, unbiased attitude and avoid conflicts of interest

(d) Report to an appropriate authority [usually the audit committee] so that they can fulfil their responsibilities

(e) Be free from interference in determining the scope of their work, performing the audit, and communicating results

(f) Refrain from assessing specific operations for which they may have responsibility

3.2 The independent action of internal audit is central to its purpose, and assumes the following:

Objectivity	Judgements are made in a state of detachment from the situation or decision
Impartiality	Not taking sides, in particular not being influenced by office politics in determining the work carried out and the reports given
Unbiased views	Avoiding the perception that internal audit is out to 'hit' certain individuals or departments
Valid opinion	The audit opinion should be based on all relevant factors, rather than being one that pleases everyone
No spying for management	Internal audit should serve the whole organisation as managers who target staff might be covering up their own inadequacies
No 'no-go areas'	Being kept away from certain areas will fatally undermine the usefulness of internal audit and mean that aggressive (incompetent?) managers are not checked
Sensitive areas audited	Internal audit must have the abilities and skills to audit complex areas effectively
Senior management audited	Internal audit must cover the management process and not just audit the detailed operational areas
No backing-off	Audit objectives must be pursued fully in a professional manner and auditors must not allow aggressive managers to deflect them from doing necessary work and issuing valid opinions

Lecture example 1

Exam standard question

Required

How could the independence of internal audit be compromised, and what measures could be taken by management to avoid this occurring? [6 marks]

Solution

4 Internal and external audit

4.1 **Internal auditors** are [normally] employees of the organisation whose work is designed to add value and who report to the audit committee.

4.2 **External auditors** come from accountancy firms and their primary role is to scrutinise accounting records so as to report to shareholders on the truth and fairness of the financial statements.

4.3 The following table highlights the key differences between internal and external audit.

	Internal audit	**External audit**
Purpose	Internal audit is an activity designed to add value and improve an organisation's operations and performance.	External audit is carried out to enable auditors to express an opinion on the financial statements.
Reporting to	Internal audit reports to the board of directors, or others charged with governance, such as the audit committee.	The external auditors report to the shareholders, or members, of a company on the truth and fairness of the accounts
Relating to	Internal audit's work relates to all the operations of the organisation.	External audit's work relates to the financial statements. They are concerned with the financial records that underlie these.
Relationship with the company	Internal auditors are usually employees of the company, although sometimes the internal audit function is outsourced.	External auditors must be independent of the company and its management. The shareholders appoint them.

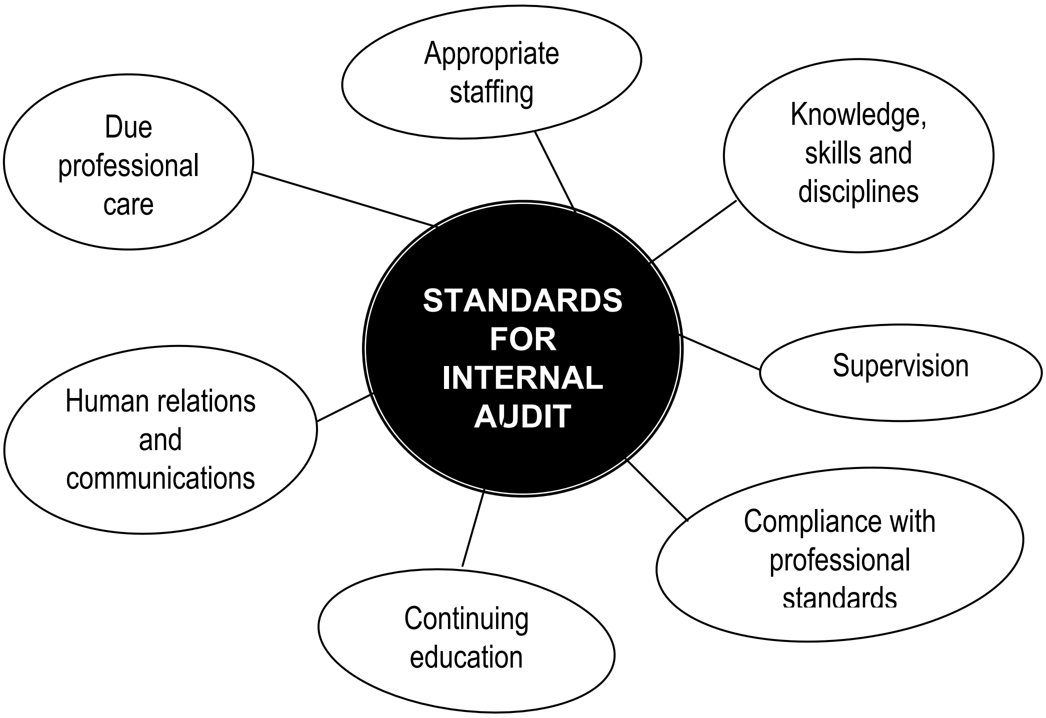
5 Management of internal audit

5.1 For the internal audit function to operate effectively, it must be managed well.

5.2 To achieve this, the following are necessary:

(a) A clearly stated purpose, with explicit and implied authority
(b) Planned activities with adequate levels of resource
(c) Access to all areas of the organisation
(d) Complete and accurate information
(e) Approved policies and procedures
(f) Competent staff with the necessary skills, and a programme for staff development
(g) A quality assurance system.

5.3 Internal audits should be performed with proficiency and professionalism. There are specific standards on the following areas to meet this.



6 The role of the audit committee

6.1 The board through the audit committee should conduct an annual review of the internal auditors' work.

6.2 The review should consider:

(a) The formal terms of reference and assess whether they are adequate

(b) Whether there are adequate safeguards in place to ensure the independence of internal audit

(c) The documentation provided by internal audit

(d) Resourcing plans to ascertain if there will be sufficient resources to review all areas

6.3 The main duties of the audit committee are likely to be as follows.

(a) Review of:

(i) financial statements,
(ii) financial reporting, and
(iii) budgetary systems.

(b) Review of internal audit, including the following aspects:

  (i) Standards [including objectivity, technical knowledge and professional standards]

  (ii) Scope of work undertaken

  (iii) Work plan, especially review of controls and coverage of high-risk areas

  (iv) Sufficiency and capability of resources

  (v) Reporting arrangements

(c) Review of the adequacy internal control systems, including the statement on internal controls prior to its approval by the board.

(d) The risk of fraud, and mechanisms in place for fraud to be investigated.

(e) Consider the recommendations of the external auditors in the management letter.

(f) Review of risk management confirming that there is a formal policy in place for risk management and that the policy is backed and regularly monitored by the board.

Lecture example 2

Class discussion

Required

What are the benefits that an audit committee can bring to an organisation, particularly with respect to internal audit and internal control?

Solution

7 Chapter summary

Section	Topic	Summary
1	The Role of Internal Audit	Internal Audit is a form of control put in place by the board to help achieve the company's objectives. Companies with no internal audit function should review the need for one annually and consider whether they need one in light of their: size; complexity; changes in risks; internal changes; adverse events.
2	Objectives of Internal Audit	SCREAM
3	Independence	Internal audit needs to be carried out objectively. The internal auditors must remain as independent as possible and avoid conflicts of interest, such as self review. They require authority and should report directly to the board (or a sub-committee)
4	External Audit	External audit is carried out by accountancy firms in order to report on the truth and fairness of the financial statements. Internal auditors are often employees of the company and the scope of their work is much wider, extending beyond finance into all areas of the business (eg quality control)
5	Management of Internal Audit	Internal auditors need to act professionally. They require clear objectives and adequate skills.
6	The Role of the Audit Committee	The internal audit committee is particularly important under Sarbanes-Oxley, which requires a mandatory audit committee of independent NEDs. Their role encompasses: nomination and liaison with external auditors, authorising any permitted non-audit work; oversight of all aspects of internal audit; review of all information that may affect share price before publication; receive and handle issues raised by whistleblowers.

END OF CHAPTER

Business risks

6

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Define and explain risk in the context of corporate governance
- Define and describe management responsibilities in risk management
- Define and compare (distinguish between) strategic and operational risks
- Define and explain the sources and impacts of common business risks
- Recognise and analyse the sector or industry specific nature of many business risks

Exam Context

You may be able to gain some marks for understanding basic risk concepts. When trying to identify risks in the exam, consider the scenario and in particular what aspects of the scenario are currently changing – these will point you towards important risks.

The most important question though when considering what risks could affect an organisation is 'what could go wrong?'.

Qualification Context

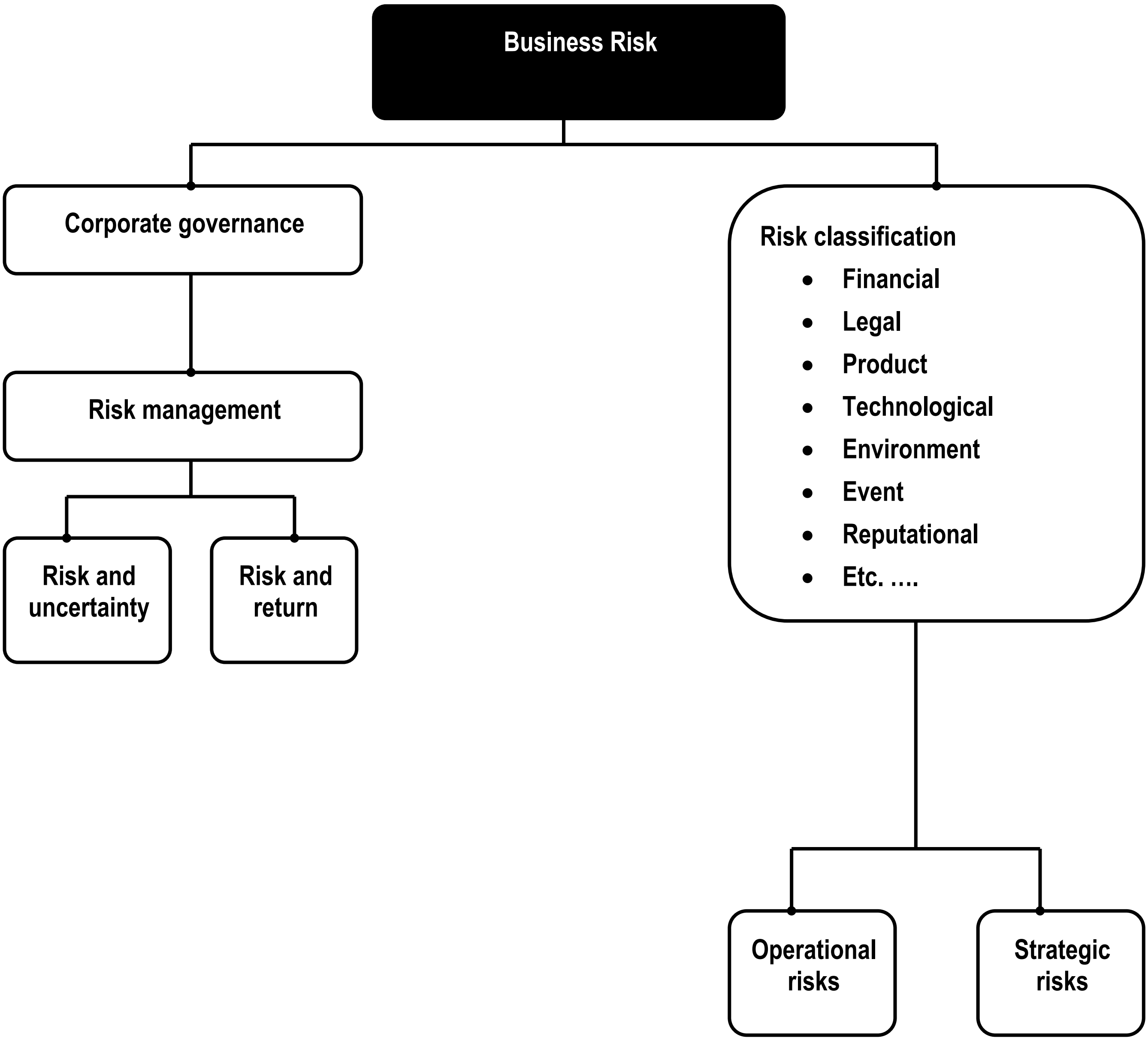
You will have encountered the concept of risk throughout your studies, from F1, Accountant in Business where you consider the influences over a business performance to F9 Financial Management where you undertake a very technical detailed review of different risks.

You might go on to do detailed calculations for treasury risk in P4, Advanced Financial Management, cover risk from a strategic point of view in P5, Advanced Performance Management or use risk to plan effective audits in P7, Advanced Audit and Assurance.

Business Context

The relationship between risk and return is key to a successful business. A business that does not take any risks will not make any profits. Instead businesses are trying to make returns that are acceptable for the risks that they take. Therefore, it is important to understand that organisations do not seek to eliminate all risks, rather to effectively manage them. This way the positive or upside to the risk can reap benefit whilst the negative downside can be minimised.

Overview


Business Risk
Corporate governance
Risk management
Risk and uncertainty
Risk and return
Risk classification
• Financial
• Legal
• Product
• Technological
• Environment
• Event
• Reputational
• Etc. ….
Operational risks
Strategic risks

1 Risk and uncertainty

1.1 **Risk** is a condition in which there exists a dispersion in the possible results of an activity.

1.2 Although we normally consider risk to mean the chance of negative outcomes, risk assessment should also consider "upside" risk, the chance of a better than expected outcome.

1.3 Risk arises from **uncertainty**, which in turn rises from incomplete information.

1.4 Ultimately risk assessment may be able to tell you the possible impacts and the chances that each outcome will occur (risk probability). All that is unknown is the actual outcome, which will always be uncertain.

2 Risk and return

2.1 Businesses may be willing to tolerate a higher level of risk (a wider range of possible outcomes, a higher probability of negative outcomes) provided they receive a higher level of return; this is their **appetite for risk**.

2.2 The acceptance of a degree of risk is necessary in business to compete successfully and grasp new opportunities. It is expected by shareholders, who themselves ultimately bear the risk of a business.

2.3 A business should reduce the negative aspects of risk where possible, but not eliminate all risks because of its positive aspects.

2.4 The role of organisational management is to maximise the returns that are possible given the levels of acceptable risk.

3 Risk management

3.1 Risk management is an integral part of strategy, and involves analysing the key value drivers in the organisation's activities, and the risks associated with those value drivers.

3.2 A simplistic view of risk would see it in purely negative terms, as **downside risk**. Here, risk management would aim to minimise the chances that such adverse events will occur.

3.3 However, organisations should be aware that it might not be possible to eliminate risks without undermining the whole basis on which the business operates or without incurring excessive costs and insurance premiums.

3.4 There will be a level of **residual risk**, which it is simply not worth or possible to eliminate.

3.5 The benefits derived from risk management, possibly at the expense of profits, are:

(a) The predictability of cash flows
(b) Limitation of the impact of potentially bankrupting events
(c) Increased confidence of shareholders and other investors

4 Risk and corporate governance

4.1 There needs to be a link between directors' remuneration and risks taken by the organisation.

4.2 Directors need controls or incentives to ensure the risk appetite of the company matches shareholder expectations otherwise directors could decide that the company should accept a level of risk higher than shareholders consider acceptable.

4.3 Corporate governance frameworks aim to ensure that directors pay sufficient attention to risk management and take appropriate risks. Corporate governance guidelines therefore require directors to:

(a) Establish appropriate control mechanisms for dealing with the risks the organisation faces

(b) Monitor risks themselves by regular review and a wider annual review

(c) Disclose their risk management processes in the accounts.

5 Strategic risks

5.1 Strategic risks are those risks that relate to the fundamental long term decisions that directors take about the future of an organisation.

5.2 The most significant risks are focused on the actual strategy the organisation adopts. This will include issues such as:

Lecture example 1 **Class discussion**

Required

What other factors could influence the degree of strategic risk faced by a company?

Solution

6 Operational risk

6.1 **Operational risk** is the risk of loss from a failure of internal business and control processes.

6.2 Operational risk includes losses arising from

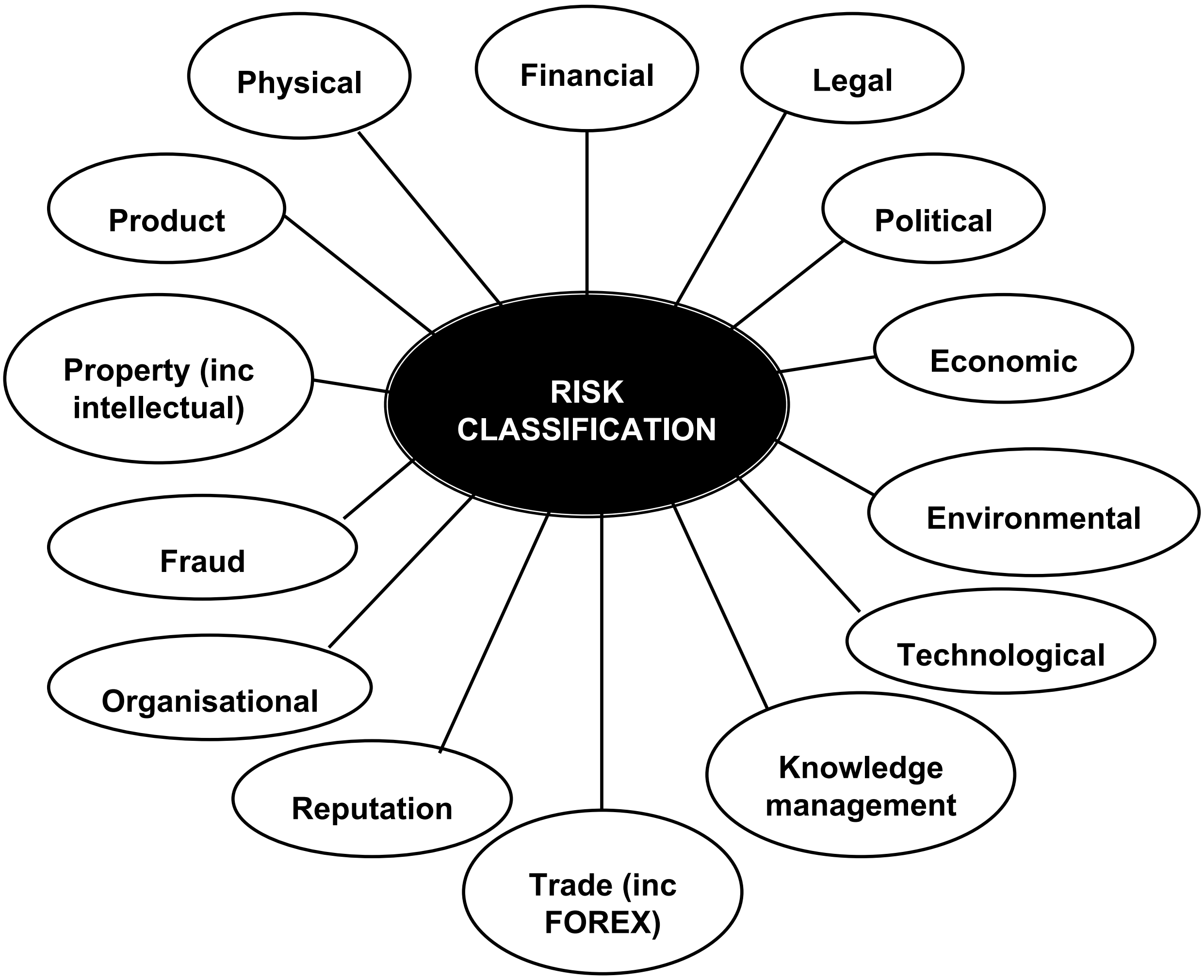
(a) Internal control/audit inadequacies
(b) IT failures
(c) Human error
(d) Loss of key-personnel
(e) Fraud
(f) Business interruption.

6.3 The main difference between strategic and operational risks is that strategic risks relate to the long term and are derived in part from the external environment. Operational risks are what could go wrong on a day-to-day basis, and are internally focused.

7 Classification of risk

7.1 There are many different types of risks faced by organisations, particularly those with commercial or international activities.

7.2 The nature of these risks can be classified under the several key headings, as illustrated below.



Lecture example 2

Class discussion

Required

Suggest the various aspects of business and financial performance that could contribute to financial risk.

Solution

Lecture example 3

Class discussion

Required

Suggest various ways in which technological risk could manifest itself in a large business organisation.

Solution

Lecture example 4

Class discussion

Risky Business

A & B is a European retail company that has had a presence on the high street in its home country for decades. It traditionally sold high quality, own brand goods. Its range covers clothing, food and groceries and furniture / household items. It acquired a reputation for being the place where everybody bought their socks and underwear. It also attracted a lot of seasonal Christmas sales in both the clothing ranges (because of its generous returns policy) and the food ranges which are still regarded as more upmarket than rival supermarkets.

In the 1990's and early 2000's it was being described in the press as a 'troubled' retail chain because of its lacklustre performance. Among the problems it faced were late adoption of EFTPOS, a 'conservative' clothing range, while its traditional demographic were increasingly youthful in their outlook and issues regarding the quality and value for money of the clothing after production was moved from its home country to parts of the world with cheaper labour. The brand had a tired feel to it.

The company has had mixed success in turning its fortunes around. It has had several changes on the board, including both the posts of Chair and CEO. There have also been changes in the design team for the women's clothing ranges. The company launched several "collections" aimed at different groups of women, including "xclusiv", "pour Elle" and "traditional"

Other strategies being rolled out are to gain a reputation for exemplary social and environmental policies, diversifying into financial products, online selling and establishing branches across the rest of Europe and North America. These have sought to link the brand to the (positive) values and characteristics associated within its home country.

Required:

Analyse the risks facing the company.

Solution

8 Chapter summary

Section	Topic	Summary
1	Risk and Uncertainty	Risk describes situations with a range of possible outcomes. Hazard or down-side risk can describe negative outcome and up side risk positive outcomes. Risk arises from uncertainty or incomplete information.
2	Risk and Return	Higher risks are usually associated with higher returns. This means that companies would not want to eliminate all risk even if that was possible because of the loss of business opportunities.
3	Risk Management	Risk management means analysing the company's exposure to risk and deciding on an appropriate response.
4	Risk and Corporate Governance	The directors should ensure that the risk appetite of the company matches the expectations of investors. Corporate Governance frameworks seek to ensure that directors consider risk and act appropriately.
5	Strategic Risks	Strategic Risk is the chance that strategic decisions will fail. It relates to long term, fundamental decisions such as entering or exiting markets, mergers and acquisitions
6	Operational Risk	Operational risk is the chance of incurring loss from short term, internal operational decisions, such as IT problems, employee fraud, and business interruption.
7	Classification of Risk	Businesses classify risk in whatever way is most appropriate to them. A useful list in exams is; Product, Event, Financial, Economic, Technological. Reputation risk is sometimes called the risk of risk as successful management of other risk can reduce it. It is the risk of a detrimental change in the perceptions of others with regard to the business.

END OF CHAPTER

Risk assessment

7

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Identify, and assess the impact upon, the stakeholders involved in business risk
- Explain and analyse the concepts of assessing the severity and probability of risk events
- Describe and evaluate a framework for board level consideration of risk

Exam Context

You may be asked to describe the risk analysis framework in the exam, or be given details about particular stakeholders whose views are important.

Most importantly when considering risks described or implied in a scenario, you need to assess the risk probabilities and the impacts (what will happen if the risk materialises). Although you may only be able to do this very roughly, it may well determine which risks you concentrate on in your answer; the more significant the risk, the more depth of discussion will most likely be required.

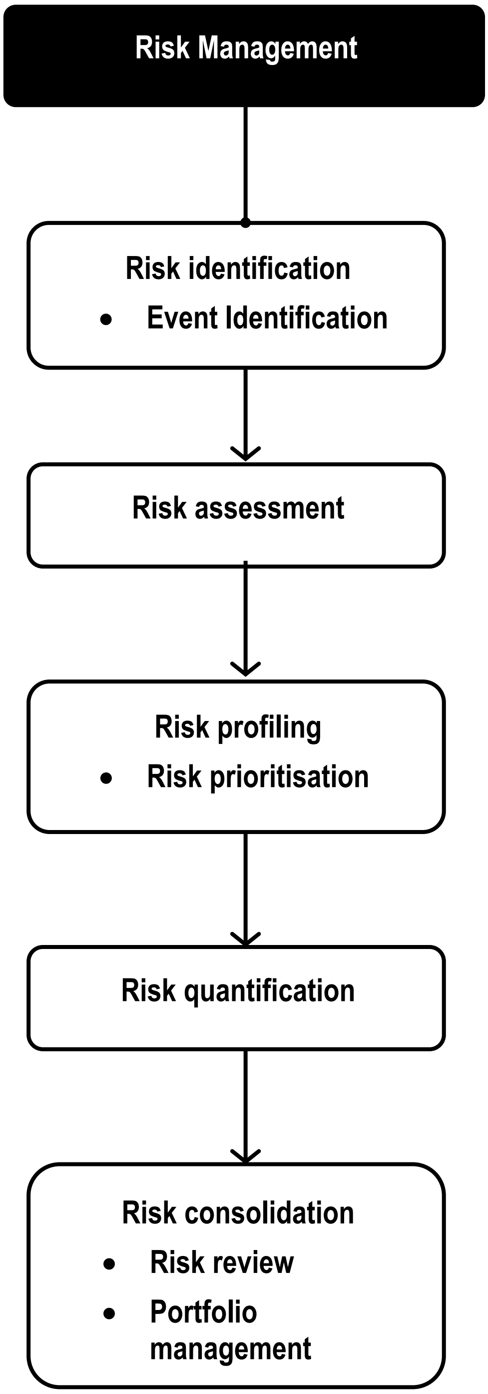
Qualification Context

Aspects of the risk management process are examined elsewhere in for example detailed calculations in Financial Management and the business environment in Business Analysis. This paper takes a broad view of the whole process of identifying and managing risk.

Business Context

The very existence of business risks in all of its forms means that an organisation needs to employ effective risk management measures. The adoption of a structured and methodical approach, which considers risk holistically, consistently and iteratively, ensures a business is best placed to take appropriate mitigating action.

Overview


Risk Management
Risk identification
• Event Identification
Risk assessment
Risk profiling
• Risk prioritisation
Risk quantification
Risk consolidation
• Risk review
• Portfolio management

1 Risk analysis

1.1 Risk analysis is made up of five stages:

- Identification
- Assessment
- Profiling
- Quantification
- Consolidation

2 Risk identification

2.1 The identification of risks before they materialise makes it easier for management to identify suitable methods that can be used to manage them.

2.2 Risk identification is a **continuous (or iterative) process**, so that new risks and changes affecting existing risks may be identified quickly and dealt with appropriately, before they can cause unacceptable losses.

2.3 A key aspect of risk identification [emphasised by the COSO *Enterprise Risk Management Framework]* is identification of **events** that could impact upon implementation of strategy or achievement of objectives.

2.4 Events analysis includes identification of:

(a) **External events** such as economic changes, political developments or technological advances

(b) **Internal events** such as equipment problems, human error or difficulties with products

(c) **Trends and root causes**. Once events have been identified, management may find that assessment and treatment of causes is a more effective solution than acting on individual events once they occur

(d) **Escalation triggers**, certain events happening or levels being reached that require immediate action

(e) **Event interdependencies**, identifying how one event can trigger another and how events can occur concurrently. For example, a decision to defer investment in an improved distribution system might mean that downtime increases and operating costs go up

2.5 Events can be **classified** horizontally across the whole organisation and vertically within operating units. This gives management a better understanding of the interrelationships between events, gaining enhanced information as a basis for risk assessment.

3 Risk assessment

3.1 It is not always simple to forecast the financial effect of a possible disaster, as it is not until *after* a loss that all the impacts – the extra expenses, inconveniences and loss of time can be recognised. Assessment involves estimating or otherwise establishing the impact of possible outcomes, and their likelihood.

4 Risk profiling

4.1 This stage involves using the results of a risk assessment to group risks into risk families. One way of doing this is a likelihood/consequences matrix.

Consequences (impact)

Likelihood (risk probability)	*Low*	*High*
Low	Loss of suppliers of small scale and unimportant inputs	Loss of key customers Failure of computer systems
High	Loss of lower-level staff	Loss of senior or specialist staff Loss of sales to competitor Loss of sales due to macroeconomic factors

4.2 This profile can then be used to set priorities for risk mitigation.

4.3 The main limitation of this approach is that it rests upon the assumption that both impact and risk can be quantified, or at least ranked, but quite often they can't.

5 Risk quantification

5.1 Risks that require more analysis can be quantified, where possible results or losses and probabilities are calculated and distributions or confidence limits added on. From this exercise the organisation can ascertain certain key figures.

(a) Average or expected result or loss
(b) Frequency of losses
(c) Chances of losses
(d) Largest predictable loss

5.2 The examiner has stated that you won't be expected to carry out any calculations in the exam.

6 Risk consolidation

6.1 Risk needs to be consolidated at the corporate level.

6.2 This aggregation will be required as part of the overall review of risk that the board needs to undertake under corporate governance provisions.

7 Stakeholders' responses to risk

7.1 Businesses should be aware of stakeholder responses to risk as this could have an adverse effect on their business.

<table>
<tr><td>Shareholders are not necessarily risk averse, but they will expect higher returns from high risk companies. They may well have acquired their shares to fit into a balanced portfolio. They will be concerned if there is an unexpected change in the company’s risk appetite and may choose to invest elsewhere.</td></tr>
<tr><td>Debt providers are most concerned about the risk of non-payment, They can take various actions with potentially serious consequences such as:
Denial of credit
Higher interest charges,
Applying restrictive covenants
Requiring security (e.g. mortgage)
Putting the company into liquidation.</td></tr>
<tr><td>Employees will be concerned about threats to their job prospects (money, promotion, benefits and satisfaction) and ultimately threats to the jobs themselves. The variety of actions employees can take include:
Pursuing of their own goals rather than shareholder interests
Industrial action,
Refusal to co-operate
Resignation</td></tr>
<tr><td>Customers will be concerned with threats to their getting the goods or services that they have been promised, or not getting the value from the goods or services that they expect. The risk to the firm is that they could take their business elsewhere.</td></tr>
<tr><td>Governments, regulatory and other bodies will be particularly concerned with risks that the organisation does not act as a good corporate citizen, implementing for example, poor employment or environmental policies. A number of the variety of actions that can be taken could have serious consequences.
Government can impose tax increases or regulation or take legal action
Pressure groups tactics can include publicity, direct action, sabotage or pressure on government or other stakeholders.</td></tr>
</table>

8 Board consideration of risk

8.1 The risks facing an organisation should influence the ways in which the board develops its internal control systems. This is a key component of good corporate governance

8.2 The Turnbull report laid out a framework for board consideration of risk and internal control, in which the board should consider:

(a)	The nature and extent of the risks facing the company
(b)	The extent and categories of risk which it regards as acceptable for the company to bear
(c)	The likelihood of the risks materialising
(d)	The company's ability to reduce the incidence and impact on the business of risks that do materialise
(e)	The costs of operating particular controls relative to the benefits obtained in managing the related risks

8.3 The Turnbull Report recommends that the board should regularly receive and review reports on risk management and internal control.

8.4 Turnbull also recommends that directors should conduct an annual review of risk and internal control.

9 Chapter summary

Section	Topic	Summary
1	Risk Analysis	Risk analysis is made up of five stages from risk identification and to risk consolidation.
2	Risk Identification	Risk identification is a continuous process. COSO emphasises events which may impact on business objectives. Events may be internal or external. Events analysis should consider trends, triggers and interdependencies.
3	Risk Assessment	Risk assessment is the process of establishing impacts and probabilities of events. This information is then used for risk profiling
4	Risk Profiling	One method of profiling is to position the risk event within a probability/impact matrix. This process helps establish priorities for risk mitigation
5	Risk Quantification	Calculations can establish the distribution of outcomes, confidence limits for outcomes, expected outcomes, frequency or probability of outcomes and largest predictable losses. There are no calculations in this exam.
6	Risk Consolidation	Risk consolidation will involve aggregating and categorising the risks analysed. It will be part of the high level review of risk.
7	Stakeholders Responses to Risk	Shareholders will expect higher returns from higher risks. They may react negatively to changes in the risk of the company. Suppliers and lenders will respond to risk of non-payment Employees will respond to risks associated with job prospects and security. Customers will respond to threats to the provision of goods and services. Government and regulators will respond to threats to corporate citizenship and compliance.
8	Board Consideration of Risk	In order to operate a sound system of internal controls the board should thoroughly and regularly evaluate the nature and extent of the risks to which the company is exposed. The board considers the risk the company faces and what risk it is acceptable for the company to bear. They should consider the likelihood and impact of risks and the cost / benefit of operating particular controls.

END OF CHAPTER

Controlling risk

8

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Identify, explain and evaluate the corporate governance and executive management roles in risk management (in particular the separation between responsibility for ensuring that adequate risk management systems are in place and the application of risk management systems and practices in the organisation)
- Explain the assess the role of a risk manager in identifying and monitoring risk
- Explain and evaluate the role of the risk committee in identifying and monitoring risk
- Explain the importance of risk awareness at all levels of an organisation
- Describe and analyse the concepts of embedding risk in an organisation's systems and procedures
- Describe and evaluate the concept of embedding risks in an organisation's culture and values
- Explain and analyse the concepts of spreading and diversifying risk and when this would be appropriate
- Define the terms risk avoidance and risk retention
- Explain and evaluate the different attitudes to risk and how these can affect strategy
- Explain and assess the necessity of incurring risk as part of competitively managing a business organisation
- Explain and assess attitudes towards risk and the ways in which risk varies in relation to the size, structure and development of an organisation

Exam Context

The chapter contents could be examined in overview (the key features of a good risk management system) or you may be asked more specific questions about various aspects such as the responsibilities of senior management or when different methods of dealing with risk might be appropriate.

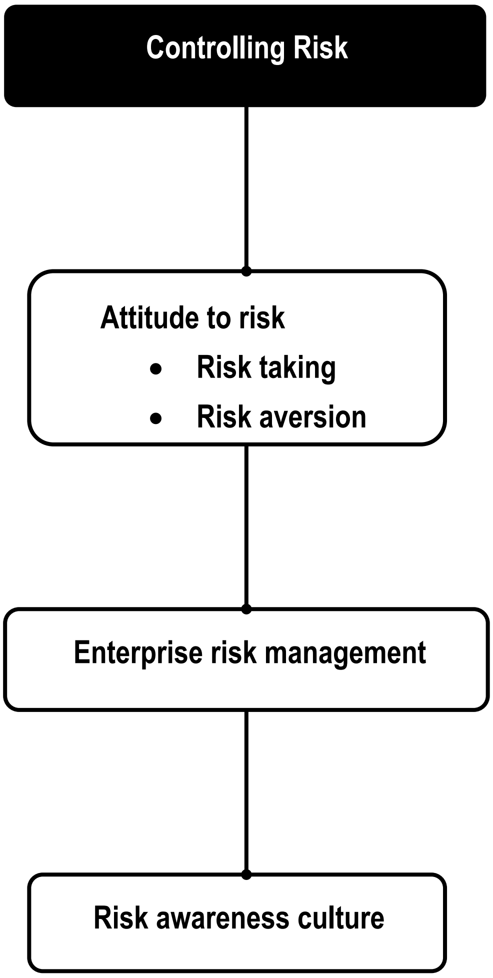
Qualification Context

During your studies at the fundamentals level you will have learned a number of financial and management accounting techniques had the effect of controlling risk in a business environment. Although not identified as such at the time, you should use this knowledge as the foundation stone to aid your understanding of the paper, and cite examples to help apply this knowledge in the exam.

Business Context

For a business to be successful it must take risks. The old adage "you need to speculate to accumulate" holds true, however risk must always be managed in a controlled environment. This chapter will help you appreciate exactly how organisations can create such a control environment and therefore affect control measures in all areas of business activity.

Overview


Controlling Risk
Attitude to risk
Risk taking
Risk aversion
Enterprise risk management
Risk awareness culture

1 Risk attitudes (appetites)

1.1 Management responses to risk are not automatic, but will be determined by their own attitudes to risk, which in turn may be influenced by shareholder attitudes.

Lecture example 1

Classroom discussion

Required

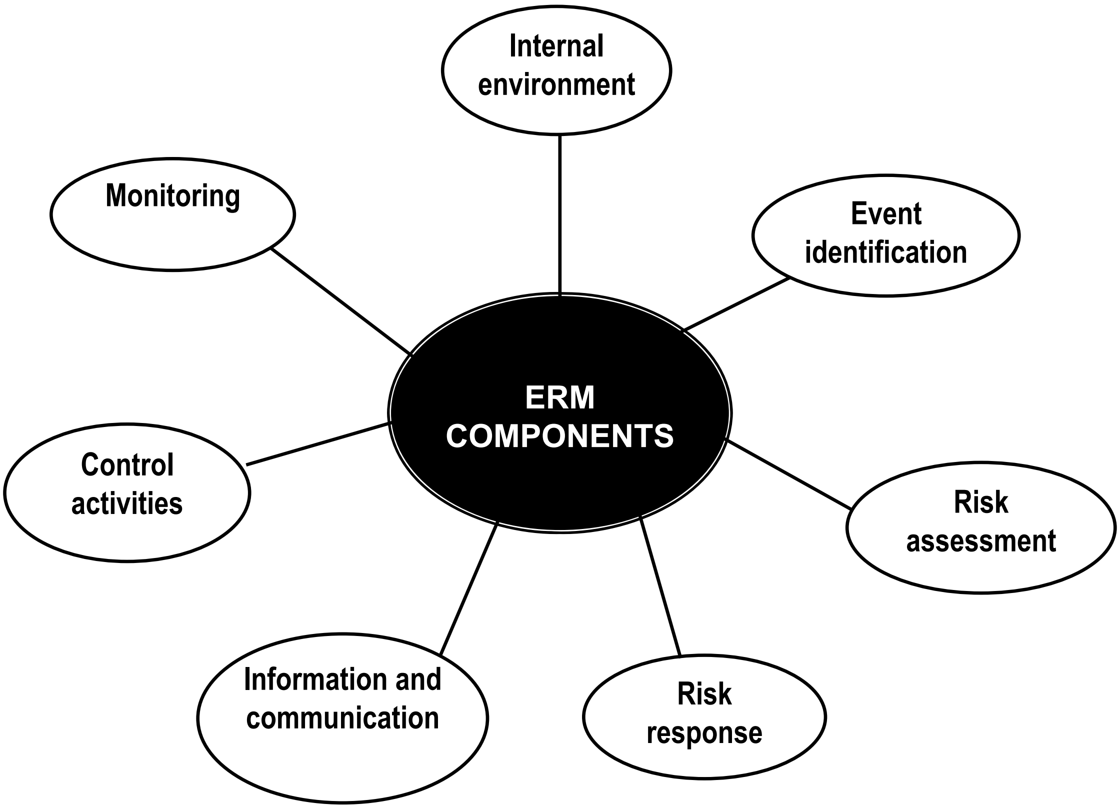
Suggest factors likely to influence an organisation's attitude to risk.

Solution

2 Enterprise risk management

2.1 Enterprise risk management [ERM] is a process, affected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise. ERM should identify potential events that may affect the organisation and manage risks to be within its risk appetite, whilst providing reasonable assurance regarding the achievement of entity objectives. *[COSO]*

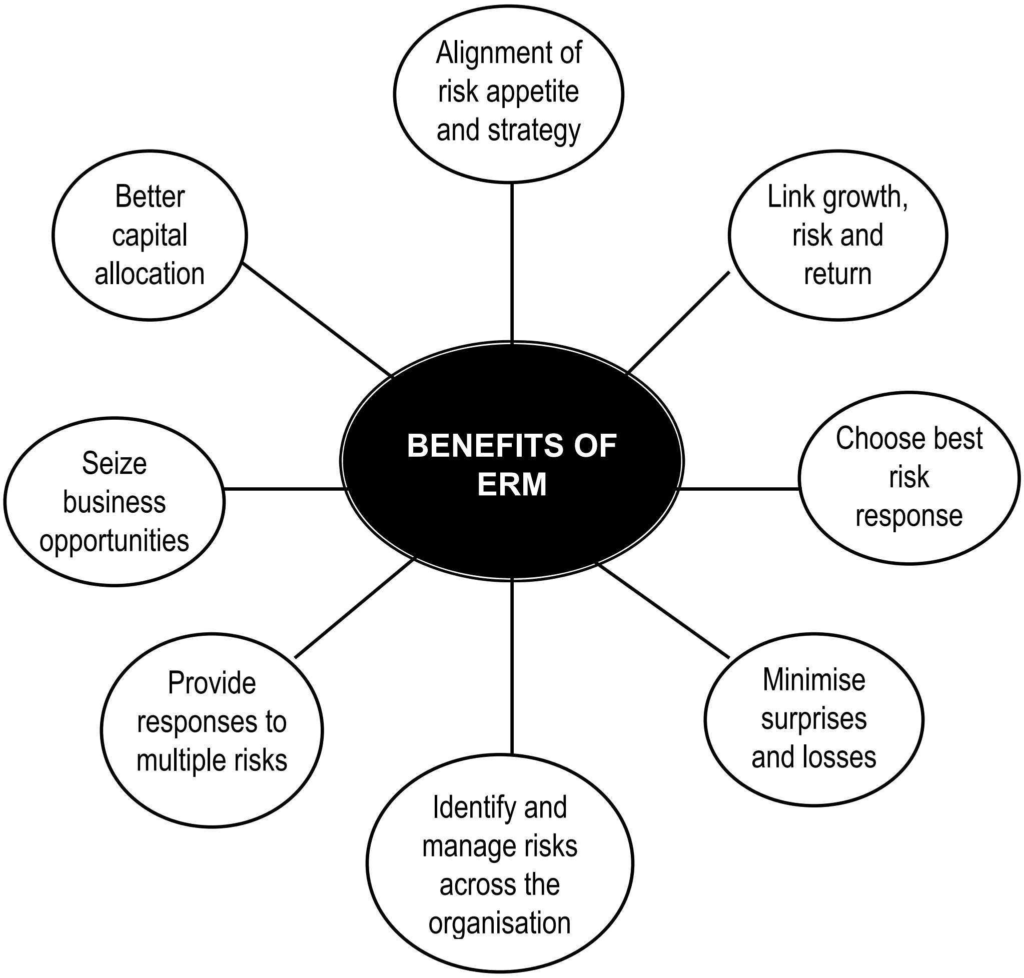
2.2 ERM provides a coherent framework for organisations to deal with risk, based on the following components:



2.3 ERM has the following characteristics.

It is a process that should ideally be intertwined with existing operations
It provides a mechanism to help understand risk, responsibilities and levels of authority.
It is applied in strategy setting, with management considering the risks in alternative strategies [scenario planning].
It is applied at all levels of the organisation from strategic planning and resource allocation, to operational-level activities and business processes.
It is designed to identify events potentially affecting the entity and manages risk within its risk appetite.
It provides reasonable assurance.
It is geared to the achievement of objectives.

2.4 Benefits of ERM



3 Embedding risk awareness and assessment

3.1 Risk management should be embedded within an organisation's processes, environment, culture, structure and systems. Organisations should issue a risk policy statement and maintain a **risk register**.

3.2 Risk management should evolve into a consistent, embedded activity within a company's strategic, business, budget and audit planning process and should focus on:

(a) Risk to stakeholder/shareholder value
(b) Consistent action-oriented risk assessment criteria
(c) Common reporting elements and style

3.3 The internal environment is an essential element of an embedded risk management approach defined in the COSO Guide *Enterprise Risk Management – Integrated Framework*.

4 Inculcating a risk aware culture

4.1 Inculcating risk awareness into an organisation's culture is best achieved by:

(a) top-down communications
(b) on what the risk philosophy is and
(c) what is expected of the organisation's people.

4.2 The COSO *Framework* recommends certain organisational measures for spreading ownership of risk management.

(a) Risk management should be an explicit part of everyone's job description.

(b) Personnel should understand the need to resist pressure from superiors to participate in improper activities, and channels outside normal reporting lines should be available to permit reporting such circumstances.

(c) Training is of course essential, especially for new employees and for all when new procedures are introduced.

(d) The people who are expected to own risks and risk management will be more inclined to take a stake in risk management.

Lecture example 2

Classroom discussion

Required

The biggest challenge likely to be encountered in developing an effective risk management culture is resistance to cultural change.

Suggest:

(a) Reasons why individuals in the firm may resists such moves
(b) How management could successfully manage the change process

Solution

5 Chapter summary

Section	Topic	Summary
1	Risk attitudes/appetites	The risk appetite of the company will be influenced by the returns expected by investors, the compliance regime and personal attitudes to risk.
2	Enterprise Risk Management	COSO provides a framework for managing and controlling risk called Enterprise Risk Management. In addition to the risk analysis ERM emphasises communication and monitoring. RM is geared towards the achievement of business objectives
3	Embedding Risk Awareness and Assessment	Risk management should be embedded within an organisation's processes, environment, culture, structure and systems.
4	Inculcating a Risk Aware Culture	A risk aware culture is achieved by communication form the top of the organisation about what is expected. Risk management should be included in job descriptions and training. The aim is spread “ownership” of risk management.

END OF CHAPTER

Information requirements and reporting

9

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Describe and assess the need to report on internal controls to shareholders
- Describe the content of a report on internal control and audit
- Explain and assess the need for adequate information flows to management for the purposes of the management of internal control and risk
- Evaluate the qualities and characteristics of information required in internal control and risk management and monitoring
- Describe and evaluate a framework for board level consideration of risk
- Describe the process of externally reporting on internal control and risk
- Explain the importance of risk awareness at all levels in an organisation

Exam Context

In scenarios, look out for information on communication links; poor communication is often an important sign of a weak control system. Board review and reporting are key elements in the control system and you'll need to know what an effective board review involves.

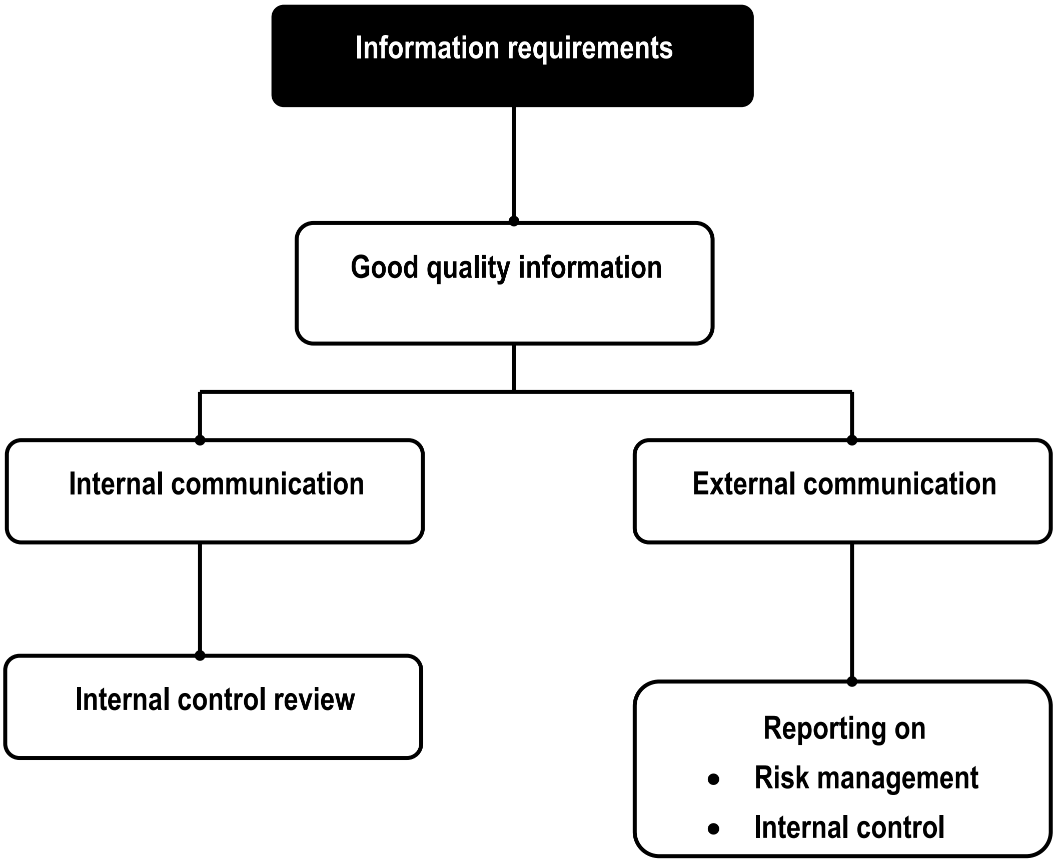
Qualification Context

Effective communication is a key trait of a successful practising accountant. Such skills are tested as a matter of course through all of the exams of the professional ACCA qualification. However, as you approach the end of your studies it is very important that you appreciate both why and how to communicate in business; this chapter provides a useful backdrop to such understanding.

Business Context

Here we will bring together a number of themes discussed earlier. The key issue is communication, in particular the importance of two-way communication between the directors and the staff. The formal review of risk and internal control undertaken by the board (or via internal audit) aims to produce a report to shareholders communicating how the firm has been addressing the major risks it faces. Formal communication of this sort in part provides assurance that the internal control systems are working well.

Overview


Information requirements
Good quality information
Internal communication
External communication
Internal control review
Reporting on
• Risk management
• Internal control

1 The information requirements of directors

1.1 Directors require information from a large variety of sources to allow them to review the operation of the internal control systems

Lecture example 1

Classroom discussion

Required

Suggest various ways in which directors can obtain the information they need to assure the effectiveness of control systems.

Solution

1.2 The information obtained from the disparate sources must be compared and discrepancies followed up and addressed.

1.3 The board must undertake a regular review of the information they receive.

1.4 Good quality information can be described using the following characteristics:

Accurate

Complete

Cost- beneficial

User targeted

Relevant to task

Authoritative

Timely

Easy to use

2 Communication with employees and internal control

2.1 Formal communication of control and risk management issues with employees reinforces both the need and importance of control systems. This is implicit within an embedded risk aware culture (discussed in Chapter 8).

2.2 Control systems may appear to work on paper but, if they are not designed with the user in mind, they are likely to be unworkable in practice.

2.3 Turnbull suggested a number of employee-related issues that management need to ensure:

(a)	Working practices encourage risk management, and discourage taking unnecessary risks
(b)	That responsibility for delivering business objectives and managing related risk is clearly understood
(c)	Problems are reported and acted upon, rather than simply left unresolved
(d)	All business activities are effectively co-ordinated (goal congruence)
(e)	All employees have sufficient knowledge, skills and resources to support the achievement of the organisation's objectives (and to manage associated risks)
(f)	The introduction and use of a well communicated risk management vocabulary across the organisation

Lecture example 2

Classroom discussion

Required

What measures could be employed by management to ensure that all staff understand that risk management is an integral, embedded part of the organisation's operations?

Solution

2.4 Good lines of communication can be difficult to achieve in large organisations and/or those operating all over the world. Their effectiveness may also vary due to differences in culture over the whole organisation.

3 Management review and reporting

3.1 Boards should review risks and the effectiveness of internal controls regularly.

3.2 To carry out an effective review, boards should regularly receive and review reports and information on internal control, concentrating on the following:

What are the risks?	What are the strategies for identifying, evaluating and managing them?
How are risks monitored and how are any weaknesses dealt with?	How effective are the management and internal control systems in the management of risk?
Are actions are being taken to reduce the risks once found?	Do the results indicate that internal control should be monitored more extensively?

3.3 The board should carry out a formal **annual review** that looks more widely at risks faced and control systems and also how these issues should be reported.

3.4 According to Turnbull, the annual review should cover:

(a)	Changes since the last formal risk assessment
(b)	The company's ability to respond to changes in its business environment
(c)	The scope and quality of management's monitoring of risk and internal control, and of the work of internal audit
(d)	The extent and frequency of reports to the board
(e)	Significant controls, failings and weaknesses which have or might have material impacts upon the accounts

4 Reporting on risk management and internal controls

4.1 The board should disclose as a minimum in the accounts:

(a) The existence of a process for managing risks,
(b) How the board has reviewed the effectiveness of the process, and
(c) That the process accords with the [Turnbull] guidance.

4.2 The board should also explicitly state within the report to the accounts:

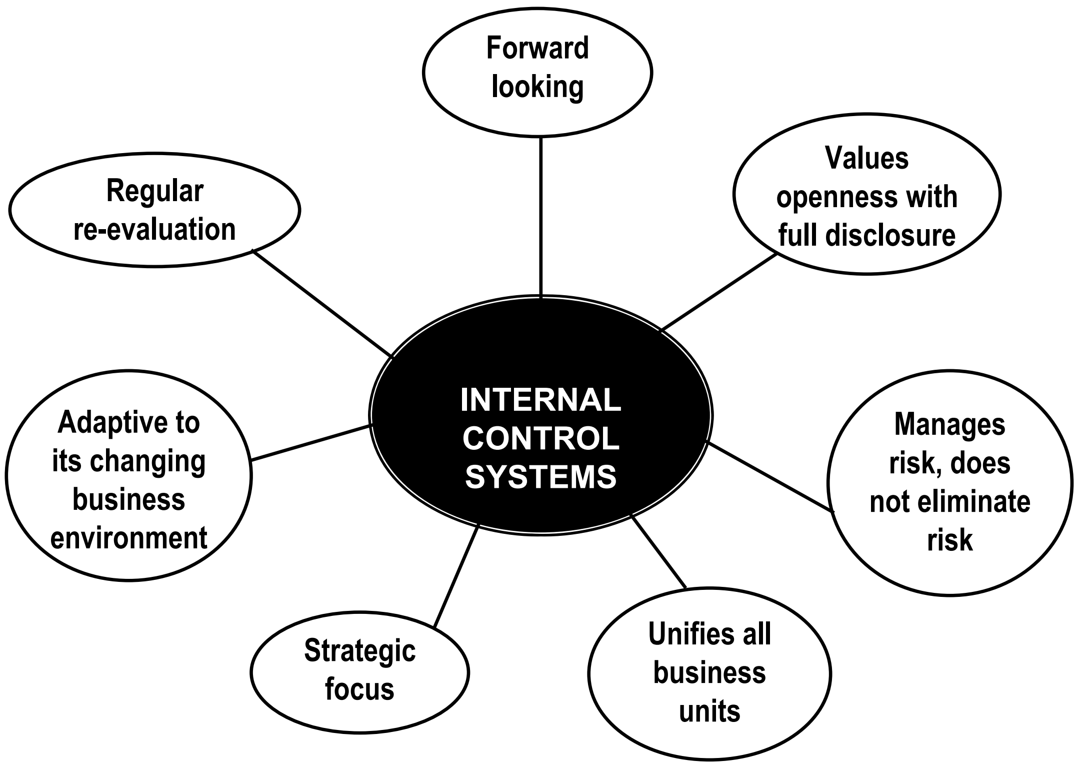
(a) A formal acknowledgement that they are responsible for the company's system of internal control, and for reviewing its effectiveness

(b) An explanation that such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives

(c) A summary of the process that the directors have used to review the effectiveness of the system of internal control

(d) Information about identified weaknesses in internal control that have resulted in material losses

4.3 The internal control system recommended by the Turnbull report is notable because it supports the following.



5 Chapter summary

Section	Topic	Summary
1	The information requirements of directors	Directors need information to review risks and controls. They should receive regular reports from the audit committee and risk committee and from operational managers. The board should regularly review the adequacy of the information it receives from all sources.
2	Communication with employees and internal control	Good lines of communication are part of a sound risk and control culture. Problems should be reported and acted upon rather than simply left unresolved. Organisational and cultural factors may create barriers to good communication.
3	Management Review and Reporting	Boards should carry out a formal annual review of risks and controls. This should be supported by regular internal reporting. The formal review should cover: changes; ability to respond to changes; quality of monitoring; adequacy of internal reporting; and, material weaknesses.
4	Reporting on Risk Management and Controls	The board makes formal disclosure to the investors of: existence of a process to control risk; confirmation that a review of effectiveness has been carried out; the process accords with a framework (Turnbull or COSO). The board acknowledges its responsibility for internal controls, explains the limitations of controls, describes the review process and highlights any material weaknesses.

END OF CHAPTER

Ethics and the public interest

10

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain and distinguish between the ethical theories of relativism and absolutism
- Explain, in an accounting and governance context, Kohlberg's stages of human moral development
- Describe and distinguish between deontological and teleological/consequentialist approaches to ethics
- Describe and evaluate Gray, Owen and Adams' seven positions on social responsibility
- Describe and evaluate other constructions of the corporate and personal ethical stance
- Describe and analyse the variables determining the cultural context of ethics and corporate social responsibility.
- Explain and explore the nature of a profession and professionalism
- Describe and assess what is meant by the public interest
- Describe the role of, and assess the influence of, accounting as a profession in the organisational context
- Analyse the role of accounting as a profession in society
- Recognise accounting's role as a value-laden profession capable of influencing the distribution of power and wealth in society
- Describe and critically evaluate issues surrounding accounting and acting against the public interest

Exam Context

Although the pilot paper contained a very a straightforward ethics question, it should be anticipated that at this level other questions may be more complex. You are likely to need to consider the range of influences on a person and/or organisation's ethical position. A typical question might ask you to interpret people's actions or attitudes in the light of the ethical theories or suggest how one of the theories might affect behaviour.

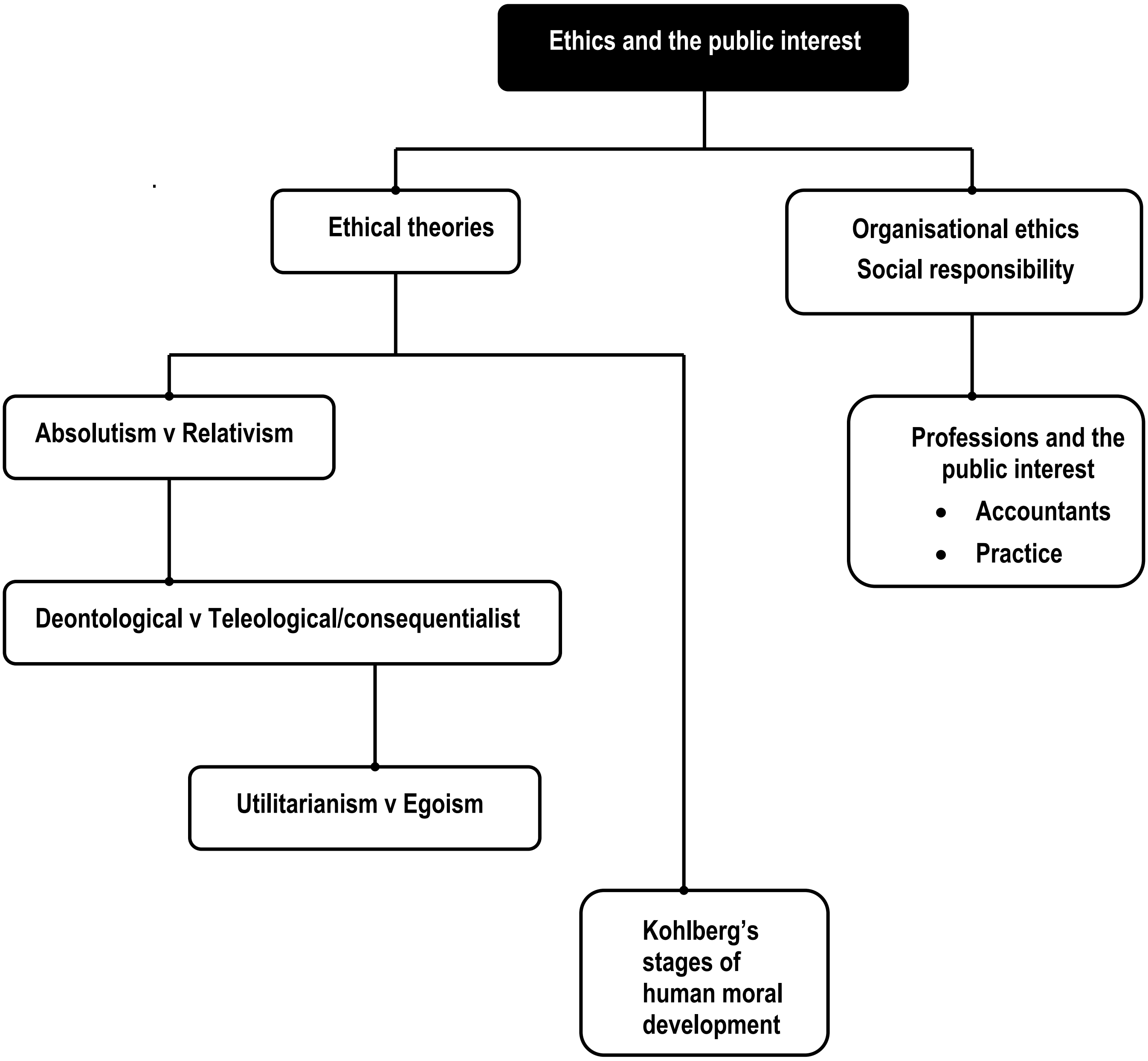
Qualification Context

The ACCA have introduced an ethics module for all accountancy students to complete. Ethics is introduced early on in the syllabus at paper F1 (Accountant in Business) and it will be a theme permeating all of the final papers.

Business Context

The International Federation of Accountants (IFAC) has deemed it necessary to provide clear and unambiguous ethical guidance to all members of the profession. The ACCA have adopted the IFAC guidelines within their rulings, which will govern your standard of behaviour as a qualified member.

Overview


Ethics and the public interest
Ethical theories
Organisational ethics
Social responsibility
Absolutism v Relativism
Professions and the public interest
• Accountants
• Practice
Deontological v Teleological/consequentialist
Utilitarianism v Egoism
Kohlberg's stages of human moral development

1 Ethical theories

1.1 Ethics is:

(a) Concerned with right and wrong, and how conduct is judged to be good or bad.
(b) About how we should live our lives and, how we should behave towards other people.
(c) Relevant to all forms of human activity, including the business world.

Relativism

1.2 Relativism denies the possibility of acquiring objective knowledge of moral principles. It suggests that all moral statements are essentially subjective and arise from the culture, belief or emotion.

1.3 Relativism recognises the differences that exist between the rules of behaviour prevailing in different cultures. This is clearly a matter of significance in the context of international business.

Lecture example 1

Exam standard question

Required

What do you consider would be the relative merits and demerits of adopting an ethically relativist approach in business? [10 marks]

Solution

Ethical absolutism

1.4 This approach to ethics is built on the principle that objective, universally applicable moral truths exist and can be known. This is called **ethical absolutism**.

1.5 The methods of establishing ethical absolutism include:

(a) Religion, based on the concept of universally applicable principles.

(b) Law, a source of reference for establishing principles.

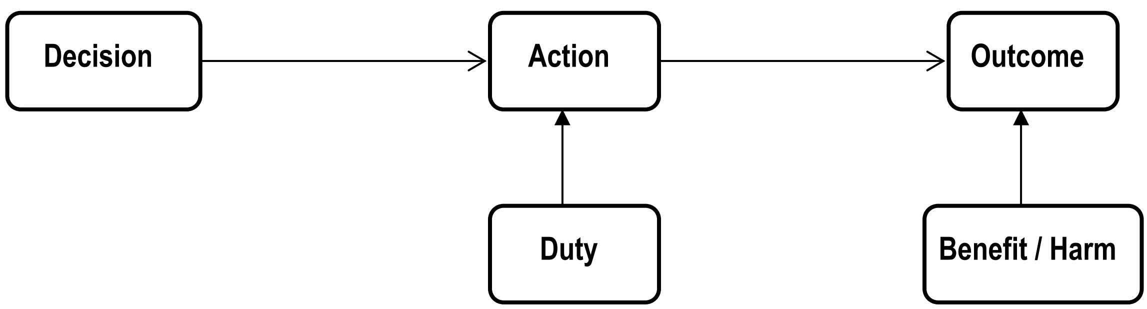
(c) Natural law approaches to ethics, based on the idea that a set of 'natural' moral rules exists and we can come to know what they are.

(d) Deontological approaches (see below).

Strengths of absolutism	Criticisms of absolutism
Absolutism lays down that there are certain unambiguous rules that people are able to follow, knowing that their actions are right.	Absolutist ethics takes no account of evolving norms within society and the development of 'advances' in morality.
The existence of absolute rules makes the application of corporate governance and comparing the performance of business units more achievable.	Irrespective of the source of absolute ethical principles, they are then subject to human interpretation with the result that different views may exist on the same issue.
	There will never be universal agreement.
	Two absolutist positions may be incompatible and therefore irreconcilable, e.g. is it permissible to tell a lie in order to save an innocent life?

Deontological v Teleological ethics

1.6 An ethical decision will lead to an action which will have consequences. A deontological approach judges the action, while a teleological approach judges the outcomes.



Deontological ethics

1.7 Deontology is concerned with the application of universal ethical principles in order to arrive at rules of conduct. Deontology lays down criteria by which actions may be judged in advance [Kant].

1.8 Deontology tests actions and establishes where your duty lies based on:

(a) Applying the rule universally and consistently.

(b) Rules should respect human dignity.

1.9 A criticism of deontological ethics is that you cannot take actions in a vacuum and must have regard for their consequences. However, we cannot always know what the consequences of our actions would be.

Teleological (or consequentialist) ethics

1.10 The teleological approach to ethics is to make moral judgements about courses of action by reference to their outcomes or consequences. Right or wrong becomes a question of benefit or harm

1.11 There are two versions of consequentialist ethics:

(a) **Utilitarianism** can be summed up in the 'greatest good' principle. This says that when deciding on a course of action we should choose the one that is likely to result in the greatest good for the greatest number of people. There problem is how do we define what is good for people.

(b) **Egoism** states that an act is ethically justified if decision-makers freely decide to pursue their own short-term desires or their long-term interests. The subject of all ethical decisions is the self.

Application in the real world

1.12 Different views may exist on morality, but a consensus may be able to be reached in certain situations. Absolutism and relativism are the ends of a spectrum, and deontology & teleological reasoning could also be regarded this way. Most people acknowledge that other views exists (relativism) while maintaining that there are some are shared values (absolutism).

1.13 This viewpoint is helpful in business situations where a range of perspectives have to be understood in order to establish a course of action. It emphasises the importance of morality as a social phenomenon; that some rules and arrangements need to be established for us to live together and we therefore need a good understanding of the different moralities that we will encounter.

2 Kohlberg's stages of human moral development

2.1 **Kohlberg** describes the **development of individuals' ethical reasoning** in terms of progression through three levels with two planes within each level. These levels can be related to ethical behaviour.

2.2 They show the reasoning process of individuals; it is possible that individuals at different levels will make the same moral decisions, but they will do so as a result of different reasoning processes.

2.3 Kohlberg emphasises how the decision is reached, not what is decided.

Level 1 Pre-conventional

- **Obedience and Punishment**: suggests that obedience is compelled by the threat or application of punishment
- **Individualism, Instrumentalism, and Exchange** considers that right behaviour means acting in one's own best interests

Level 2 Conventional

- **"Good boy/girl"** view; is an attitude that seeks to do what will gain the approval of others
- **Law and Order** means abiding by the law and responding to the obligations of duty

Level 3 Post-conventional

- **Social Contract** is an understanding of social mutuality and a genuine interest in the welfare of others
- **Principled conscience** is based on respect for universal principle and the demands of individual conscience

3 Organisations' ethical and social responsibility stances

The **ethical stance** of an organisation is described by Johnson and Scholes as **the extent to which an organisation will exceed its minimum obligation to stakeholders**.

CSR (Carroll)	**Corporate citizenship (Matten et al)**	**Ethical Stances (Johnson & Scholes)**	**7 Social Responsibility Viewpoints (Gray Owen & Adams)**
Economic Shareholders demand a good return Employees want fair employment conditions Customers seek good quality products and services at a fair price	**Limited view** voluntary philanthropy undertaken in the business's interests	**The legitimacy of the expectations and/or claims of stakeholders** Without appropriate relationships with groups such as suppliers, employers and customers, the organisation would not be able to function.	**Pristine capitalists:** Business has no moral responsibilities beyond their obligations to shareholders and creditors. **Expedients** social responsibility may be appropriate if it is in the business's economic interests.
Legal Laws codify society's moral views Obedience to the law must be the foundation of compliance with social responsibilities	**Equivalent view** is based on a wider general definition of corporate social responsibility that is partly voluntary and partly imposed	**Short-term shareholder interest**, This approach would accept a duty of obedience to the demands of the law, but would not undertake to comply with any less substantial rules of conduct.	**Proponents of the social contract** there is effectively a contract or agreement between the organisations and those who are affected by their decisions.
Ethical Companies are required to act in a fair and just way even if the law does not compel them to do so	**Extended view** is based round a partly voluntary, partly imposed view of active social and political citizenship	**Long-term shareholder interest** The responsible exercise of corporate power may prevent a build-up of social and political pressure for legal regulation.	**Social ecologists** believe that business activities result in resource exhaustion; waste and pollution must be modified. Organisations must be socially responsible **Socialists** seek to promote egalitarian equality.
Philanthropic -charitable donations, contributions to local communities, and providing employees with the chances to improve their own lives		**Shaper of society**, although it is accepted that this role is largely the preserve of public sector organisations.	**Radical feminists** aim to promote feminine values such as co-operation **Deep ecologists** suggest that man has no greater rights to resources or life than other species.

4 Professions and the public interest

4.1 IFAC's code of ethics defines professionalism in terms of professional behaviour.

4.2 Professional behaviour imposes an obligation on professional accountants to comply with relevant laws and regulations and avoid any action that may bring discredit to the profession.

4.3 Among the most important obligation for modern professionals is maintaining confidentiality and upholding ethical standards.

4.4 The **public interest** is considered to be the collective well-being of the community of people and institutions the professional accountant serves, including clients, lenders, governments, employers, employees, investors, the business and financial community and others who rely on the work of professional accountants (IFAC).

Influence of the accountancy profession on organisations

4.5 The influence of the accountancy profession on business and society is potentially huge. It can be established simply by considering all the different involvements that accountants have:

(a) Financial accounting
(b) Audit
(c) Management accounting
(d) Consulting
(e) Taxation

4.6 The financial information included within accounts can have a number of impacts:

Mechanistic issues, where the accounts are used to judge the performance of a company or its directors in line with a regulation or contract.	**Judgemental issues** are where the figures in the accounts influence the judgement of their users.

4.7 Critics of the accountancy profession emphasise the prime role of resource allocation, and thereby act as the agent of capitalism.

4.8 They argue that accountancy regulations:

(a) Are too passive, allowing too great a variety of accounting treatments, and failing to impose meaningful responsibilities on auditors such as an explicit responsibility to detect and report fraud

(b) Emphasise the wrong principles, giving priority to client confidentiality over disclosure in the wider public interest

5 Chapter summary

Section	Topic	Summary
1	Ethical Theories	Ethics is concerned with issues of right and wrong. Relativism is the belief that ideas of right and wrong are subjective. Relativism contrasts with absolutism, the belief that there are universal, objective moral truths. Deontological ethics establishes rules for how you should or should not act depending on the rightness of the action. Teleological or consequentialist ethics looks beyond the action to the outcome. This approach can be split into two, utilitarianism which makes judgements based on the greatest good and egoism which makes judgements based on the consequences for the individual (the thief's rule).
2	Kohlberg's stages of human moral development	Kohlberg describes the development of individuals' ethical reasoning through three stages or levels. Pre-conventional: reward/punishment and self-interest Conventional: "good boy/girl" and legal or social conventions Post-conventional: concern for others and principled conscience
3	Organisations ethical and social responsibility stances	There are four different models which identify different positions that can be taken. They broadly cover stances of narrow economic self interest, wider social obligations, a more principled ethical stance through to a philanthropic position. (Carroll's CSR) The other models are: Corporate Citizenship (limited, equivalent and extended views); Ethical Stances (Shot-term shareholder, long-term shareholder, stakeholder and shaper of society); and Gray, Owen & Adams 7 positions (Pristine Capitalist, Expedient, Social Contract, Social Ecologist, Socialist, Radical Feminist and Deep Ecologist)
4	Professions and the public interest	Professions and professional bodies have a dual role, protecting the interests of their members and protecting the public interest. Professionalism means avoiding actions which would discredit the accountancy profession. Acting in the public interest means acting for the welfare of society as a whole. This may conflict with detailed professional ethical duties such as the duty of confidentiality.

END OF CHAPTER

Ethics and professional practice

11

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Describe and explore areas covered by corporate codes of ethics
- Describe, and assess the content of, and principles behind, professional codes of ethics
- Describe and assess the codes of ethics relevant to accounting professionals such as IFAC or professional body codes e.g. ACCA
- Describe and evaluate issues associated with conflicts of interest and ethical conflict resolution
- Apply commonly used ethical decision-making models in accounting and professional contexts: American Accounting Association model; Tucker's 5-question model
- Explain and evaluate the nature of impacts of ethical threats and safeguards
- Explain and explore how threats to independence can affect ethical behaviour
- Explain and analyse the content and nature of ethical decision-making using content from Kohlberg's framework as appropriate
- Explain and analyse issues related to the application of ethical behaviour in a professional context
- Describe and discuss rules-based and principles-based approaches to resolving ethical dilemmas encountered in professional accounting

Exam Context

Although it is possible to gain a few marks for describing basic ethical threats, the main focus on questions on ethics will be based on practical situations. In the scenarios provided in the exam ethical issues, and associated recommended action, will not be clear-cut.

The IFAC and the ACCA provide clear guidance on best ethical practice. However, your examiner has stated that applying other relevant codes to the situations in the exam will also gain you credit.

Qualification Context

If you haven't already, you are strongly encouraged to complete the ACCA online ethics module. Although not compulsory for existing ACCA students transiting between the old and new syllabuses, it will help to bridge the knowledge gap you will face, and be invaluable in your preparations for sitting paper P1

Business Context

Undoubtedly ethics and ethical behaviour has become an important issue in the global business world. The array of corporate scandals, often involving professional accountants, has left the public with little confidence in terms of how business is conducted. By adopting a strong professional ethics stance this should go a long way in reassuring the unconvinced that our profession, and the ACCA in particular, takes ethical practice very seriously.

Overview

Professional ethics

- **Corporate codes of ethics**
  - **Ethical conflict resolution**
    - IFAC Guidelines
    - American Accounting Association
    - Tucker 5 questions
    - Kohlberg
- **Professional codes of ethics**
  - **Independence**
    - **Threats to professional independence**
      - Self interest
      - Self review
      - Advocacy
      - Familiarity
      - Intimidation

1 Corporate codes of ethics

1.1 Organisations have responded to wide and varied pressures from external stakeholders to be seen to act ethically by publishing ethical codes.

1.2 Ethical codes contain a series of statements setting out the organisation's core values and explaining how it sees its responsibilities towards its stakeholders. They cover specific areas such as gifts, anti-competitive behaviour and so on. However, often they do little more than describe current acceptable practices.

Lecture example 1

Classroom discussion

Required

Apart from the use of ethical codes how else can an organisation aim to control and influence the ethical behaviour of staff?

Solution

1.3 Issuing an ethical code is not enough to ensure correct ethical practice. The following are also required:

(a) The commitment of the board and senior management to the code needs to be real, and it needs to be very clearly communicated to all staff.

(b) Measures need to be taken to discourage previous behaviours that conflict with the spirit and detail of the code.

(c) Staff need to understand that it is in the organisation's (and their) best interests to change behaviour, and become committed to the same ideals.

1.4 Negative aspects of ethical codes include that they:

(a) Can contain inflexible and impractical rules, which are not at all clear

(b) Are often perceived by staff as irrelevant, because they: fail to address the sort of ethical problems they are likely to encounter

(c) Are widely ignored as they are not enforced

(d) Contradict the prevailing business culture and working practices

(e) Do not reflect the true behaviour of senior management

2 IFAC professional code of ethics

2.1 The IFAC *Code of Ethics* provides a good illustration of a principle-based approach:

(a) The code clarifies up-front acceptance by the accountancy profession of their responsibility to act in the public interest.

(b) The detailed guidance is preceded by the underlying fundamental principles of ethics.

(c) The guide supplies a conceptual framework that requires accountants to identify, evaluate and address threats to compliance, and applying safeguards to eliminate the threats to reduce them to an acceptable level.

Advantages of a principles-based framework	Disadvantages of a principles-based framework
The onus on the professional accountant to think about **relevant** issues in a given situation, rather than simply avoiding a checklist of unacceptable actions.	Ethical codes cannot include all circumstances and dilemmas, so accountants need a very good understanding of the underlying principles.
A framework prevents professionals interpreting legalistic requirements narrowly to get around the ethical requirements.	International codes cannot fully capture regional cultural variations in beliefs and practice.
It allows for variations, which is important as situations differ.	Principles-based codes can be difficult to enforce legally, unless the breach of the code is blatant. Most are therefore voluntary and perhaps therefore, less effective.
It can accommodate a rapidly changing environment, such as the one in which accountants operate.	

2.2 The ACCA has published its own *Code of Ethics and Conduct* for its members, which is broadly based on the same principles as the IFAC Code.

2.3 The table below details fundamental principles upon with the code are based, which can be easily remembered using the OPPTIC mnemonic:

Fundamental principles	
Objectivity	Members should not allow bias, conflicts of interest or undue influence of others to override professional or business judgements.
Professional behaviour	Members should comply with relevant laws and regulations and should avoid any action that discredits the profession.
Professional competence and due care	Members have a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. Members should act diligently and in accordance with applicable technical and professional standards when providing professional services.
Technical standards	Members should ensure that all work undertaken is performed to the highest standards.
Integrity	Members should be straightforward and honest in all business and professional relationships.
Confidentiality	Members should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper or specific authority or unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of members or third parties.

2.4 Safeguards against breach of compliance with the IFAC and ACCA guidance include:

(a) Safeguards created by the profession, legislation or regulation (e.g. corporate governance)

(b) Safeguards within the client/ the accountancy firm's own systems and procedures

(c) Educational training and experience requirements for entry into the profession, together with continuing professional development.

Lecture example 2

Classroom discussion

Required

Ethical standards, quality control standards and auditing standards work together to ensure independence is safeguarded and good quality audits are carried out.

What additional safeguards can be included in the client/firm's own systems and procedures?

Solution

3 Models of ethical conflict resolution

IFAC Code

3.1 The IFAC Code states that firms should have established policies to resolve conflict and should consider:

(a) The facts
(b) The ethical issues involved
(c) Related fundamental principles
(d) Established internal procedures
(e) Alternative courses of action, considering the consequences of each.

American Accounting Association Model

3.2 The American Accounting Association Model frames the ethical decision as a series of answers to questions.

(a)	What are the facts of the case?
(b)	What are the ethical issues in the case?
(c)	What are the norms, principles and values related to the case?
(d)	What are the alternative courses of action?
(e)	What is the best course of action that is consistent with the norms, principles and values identified?
(f)	What are the consequences of each course of action?
(g)	What is the decision?

Tucker's 5-question model

3.3 Tucker's 5 question model is a benchmark against which to test the ethicality of a decision. Ask yourself, is the decision:

(a) Profitable?
(b) Legal?
(c) Fair and equitable?
(d) Right, which is prone to subjective judgement?
(e) Sustainable or environmentally sound?

Kohlberg's guidance

3.4 One aim of a principles-based ethical code is in effect to move subjects towards post-conventional levels of reasoning as defined in Kohlberg's framework (see Chapter 10).

3.5 The principles are meant to provide ideals towards which ethical decisions should aspire, and thereby encourage individuals to make their own ethical judgements.

Lecture example 3

Group discussion

Southern Construction, started as a small family-run business in the 1980s. John Falshaw, the founder and self-appointed chairman of the board, foresaw rapid expansion and so decided that the firm should go public. Unfortunately, the timing of this decision was unfortunate as it coincided with an economic recession, which hit the building trade very hard. The strain was too much and Falshaw suffered a massive heart attack, and was forced to retire.

In the past Falshaw had run things with a heavy hand; things were done his way or not al all! The board served as a “rubber stamp” for his decisions, and as a result, financial and operational controls were weak or non-existent.

The new chairman was trying desperately to maintain existing levels of financing. However, the firm’s bank was very unsettled by recent events, and insisted that Southern Equipment plc recruit some non-executive directors to strengthen the effectiveness of the board.

Thomas Edwards FCCA had recently retired as financial controller of a large engineering company. He was delighted when he was approached by the chairman of Southern Construction with the offer of becoming a non-executive director and chair of the yet to be established audit committee. On accepting the position, the head of internal audit, Mary Flanagan, was instructed to report directly to Edwards. New internal controls were instituted and additional internal audit staff were recruited.

One day Mary Flanagan reported that her team had found that a salesman had been submitting false expenses vouchers running into thousands of pounds. Mary, who had a reputation for integrity and thoroughness, was particularly upset because the actions were a clear violation of the Southern Equipment Code of Conduct. The salesman in question was Elmer Pearson. When asked what should be done with Pearson, she responded, “The penalty called for submitting false expense claims is summary dismissal – no exceptions”.

It transpired that Pearson would go out with another sales rep, and then both would submit an expenses claim for the same trip. Internal audit had unearthed dozens of vouchers like this, some even claiming for imaginary trips.

Edwards was concerned about the reaction of the bank if they learned about thus fraudulent activity.

Later that day, Flanagan phoned Edwards at home. She sounded upset, but wanted to talk. “I’m confused” she said, “my loyalties are being pulled in so many directions, I don’t know what to think”. She went on to point out that she had known Pearson for over 10 years, and he had always been friendly and helpful to her. She wondered if long service and loyalty to the firm deserved special consideration.

The following day Edwards confronted Pearson. Pearson admitted to the double billing and imaginary trips. When he was accused of clearly violating the Code, he said “you dictate my resignation, I’ll sign it and be out of here tonight”. Edwards responded to this by advising Pearson that if any criminal activity were involved, it wouldn’t stop there.

To this, Pearson looked incredulous and began to argue his case strongly. He was currently working on a big deal with a Japanese businessman – a market Southern Equipment had been trying to crack for some time. His budget has been cut to the bone, so he used the money from the expenses subterfuge to finance the sales pitch. All that is left on a 10 million deal is for the papers

to be signed and Pearson was the only man who had developed the personal relationship with the Japanese businessman to secure this.

Edwards sat in his office pondering about what to. The bank has just been on the phone requesting a meeting next week to discuss progress in strengthening the controls within the business.

Required

Appraise the business and ethical issues, and advise Edwards what to do.

Solution

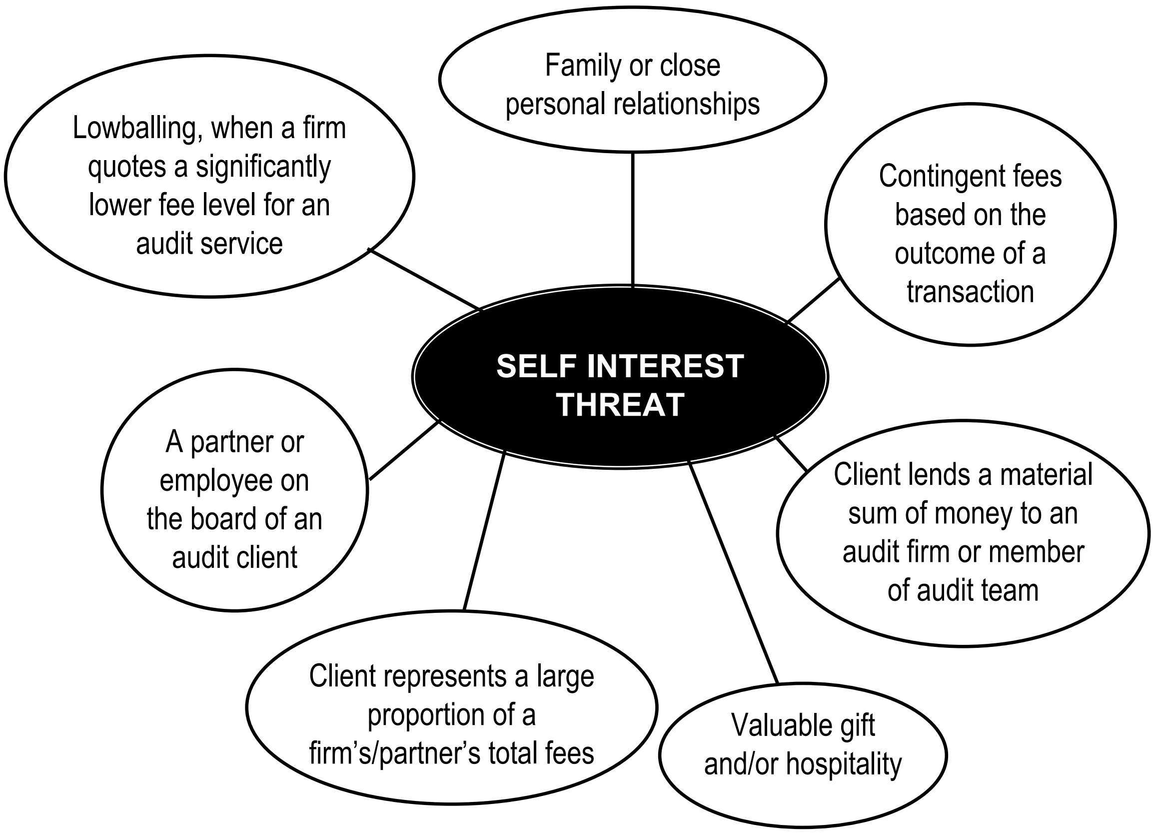
4 Independence (and conflicts of interest)

4.1 Threats to independence of action and conflicts of interest include:

- Self-interest
- Self-review
- Advocacy
- Familiarity
- Intimidation

Self-interest threat

4.2 The *ACCA Code of Ethics and Conduct* highlights a great number of areas in which a self-interest threat to independence might arise.



4.3 Safeguards in these situations might include:

(a) Discussing the issues with the audit committee of the client

(b) Taking steps to reduce the dependency on the client

(c) Consulting an independent third party such as ACCA

(d) Maintaining records such that the firm is able to demonstrate that appropriate staff and time are spent on the engagement

(e) Compliance with all applicable audit standards, guidelines and quality control procedures

Self-review threat

4.4 Self-review threat is where an audit firm provides services other than audit services to an audit client (i.e. providing multiple services). There is a great deal of guidance in the ACCA and IFAC rules about threats arising from services accountancy firms might provide to their clients.

Threat	Safeguards
If an individual had been recently involved with the client, the audit firm should consider the threat to independence arising	• Obtaining a quality control review of the individual's work on the assignment • Discussing the issue with the audit committee
Having custody of an audit client's assets, supervising client employees in the performance of their normal duties, and preparing source documents on behalf of the client also pose significant self-review threats	• Ensuring non-audit team staff are used for these roles • Involving an independent professional accountant to advise • Quality control policies on what staff are and are not allowed to do for clients • Making appropriate disclosures to those charged with governance • Resigning from the audit engagement
Preparing accounting records and financial statements, and then auditing them	• Using staff members other than audit team members to carry out work • Obtaining client approval for work undertaken
Valuation services where audited financial statements comprise the source working documents	• Second partner review • Confirming that the client understands the valuation and the assumptions used • Ensuring the client acknowledges responsibility for the valuation • Using separate personnel for the valuation and the audit
Provision of internal audit services to an external audit client is permitted in most jurisdictions, but not in the US under Sarbanes-Oxley	• The firm should ensure that the client acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls

Advocacy threat

4.5 An advocacy threat arises in certain situations where the audit firm assume the client's part in a dispute or somehow acting as their advocate. The most obvious instances of this would be when a firm acts as an expert witness in a court case.

4.6 Relevant safeguards might be:

(a) Using different departments in the firm to carry out the work
(b) Making full disclosure to the client's audit committee
(c) Withdrawal from an engagement if the risk to independence is considered too great.

Familiarity threat

4.7 Familiarity threat is where independence is jeopardised by the audit firm and its staff becoming over familiar with the client and its staff. As a result they may become too sympathetic to their views and interest.

Intimidation threat

4.8 An intimidation threat arises when a professional accountant is deterred from acting objectively by threats, actual or perceived. Situations which might create intimidation threats include:

(a) Threats of dismissal.
(b) Threats of litigation.
(c) Pressure to reduce fees or the extent of work performed.

5 An approach for examination questions

5.1 The question requirements will vary, but in general marks will be awarded for:

(a) Analysis of the situation

(b) A recognition of ethical issues

(c) Explanation if appropriate of relevant part of ethical guidelines, and interpretation of its relevance to the question

(d) Making clear, logical, and appropriate recommendations for action. Making inconsistent recommendations does not impress examiners

(e) Justifying recommendations in practical business terms and in ethical terms

5.2 As with all scenario-based questions there is likely to be more than one acceptable answer. However, questions based on ethical issues tend to produce a range of possible solutions which are, on the one hand, consistent with the ethical guidelines and acceptable, and on the other hand, a range of clearly inadmissible answers which are clearly in breach of the ethical guidelines and possibly the law.

5.3 Step-by-step approach to follow:

(a) Use the question format to structure your answer.

(b) Bear in mind what marks are being awarded for

(c) Adhere to the following list of do's and don'ts based on the American Accounting Association model.

DO	Note	DON'T
Identify the key facts as briefly as possible (one sentence?)	1	Merely paraphrase the question
Identify the ethical issues at stake, and the related norms, principles and values	2	Regurgitate the entire contents of the Ethical Guidelines
Consider alternative reasonable actions and their consequences	3	List every single possible action and then explain how all the unsuitable ones can be eliminated
Make a decision and recommend the best course of action as appropriate, based on consistency with the norms, principles and values	4	Fail to make a decision or recommend action. Propose actions in breach of the *Ethical Guidelines* or the law
Justify your decision	5	Be feeble. 'This should be done because it is ethical' is not terribly convincing

Notes to the model

1 One sentence is an ideal to aim for.

2 (a) Use the terminology of the ethical guidelines.

(b) Don't forget the words 'fairness', 'bias', and 'influence' when discussing 'objectivity'.

(c) Don't adjust the scenario to make it fit a fundamental principle.

(d) If the law is involved, don't get carried away – this is not a law exam.

3 Useful ways of generating alternatives are:

(a) To consider the problem from the perspective of the affected party

(b) To consider the problem from the point of view of the organisation and environment

4 Making a decision is often very hard, but if you cannot do this you are simply not ready to take on the responsibilities of a qualified accountant.

5 This is not actually as hard as you might think.

5.4 Possibly the most common fault in students' answers to questions on ethics is that they include large amounts of unanalysed detail copied straight from the question scenarios in their answers. This approach earns no marks!

5.5 Marks are awarded for 'justifying recommendations in practical business terms and in ethical terms'. The key to this approach is using the right language, and to a large extent you cannot help doing so if you have sensible suggestions to make. The real problem that many students experience with questions of this type is lack of confidence in their own judgement.

5.6 If you have sound business and managerial sense and you know the ethical guidelines there is every reason to suppose that an answer that you propose will be acceptable, so don't be shy of expressing an opinion.

6 Chapter summary

Section	Topic	Summary
1	Corporate Codes of Ethics	Ethical codes set out the company's core values and usually contain detailed guidance about issues like anti-competitive practices and bribes/gifts. To be effective they need board level commitment, communicating, monitoring and sanctions. Failures of codes are that they can contradict actual practice.
2	IFAC Professional Code of Ethics	The IFAC cod is a principles based code. The ACCA's code is broadly based on the IFAC code. The fundamental principals are: **O**bjectivity **P**rofessional Behaviour **P**rofessional competence and care **T**echnical Standards **I**ntegrity **C**onfidentiality
3	Models of ethical conflict resolution	The IFAC and American Accounting Association Models cover broadly the same issues. Consideration should be given to: the facts, the ethical issues, fundamental principles, internal procedures, alternatives. Tuckers 5 questions are, is the decision: Profitable? Legal? Fair? Right? Sustainable?
4	Independence and conflicts of interest	The threats to independence are: self-interest, self review, advocacy, familiarity and intimidation. Safeguards are put in place to counter these threats.

END OF CHAPTER

Social and environmental issues

12

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Describe and assess the social and environmental effects that economic activity can have (in terms of social and environmental footprints)
- Explain and assess the concept of sustainability and evaluate the issues concerning accounting for sustainability (including the contribution of full cost accounting)
- Describe the main features of internal management systems for underpinning environmental accounting such as EMAS and ISO 14000
- Explain the nature of social and environmental audit and evaluate the contribution it can make to the development of environmental accounting

Exam Context

You may see a whole optional question on the issues covered in this chapter as it covers various aspects of organisations' activities and control systems. Alternatively [as in Pilot Paper Question 1] some of the themes may be brought in as part of a wider question.

Qualification Context

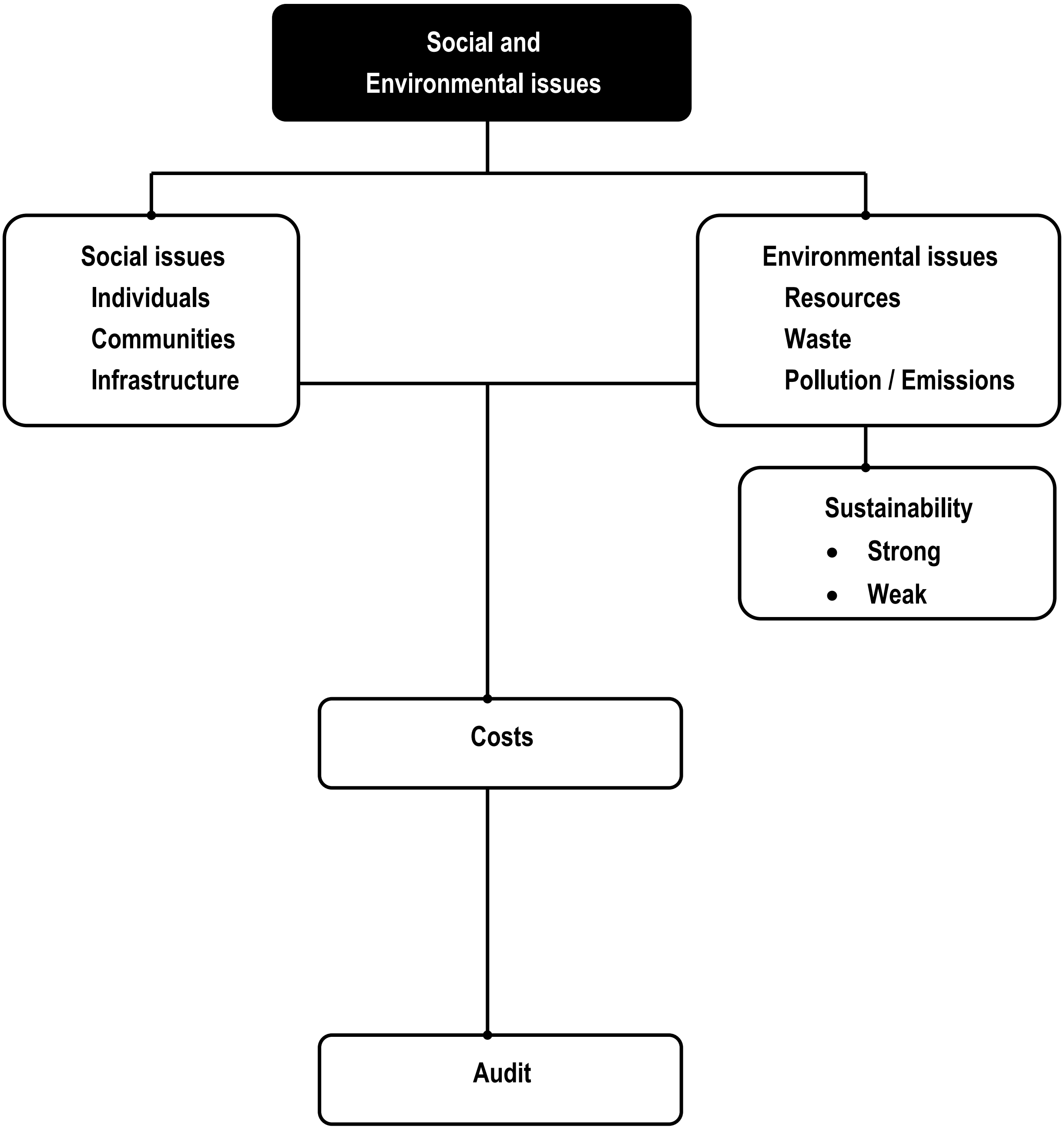
The grey area of corporate social responsibility has not been addressed in your studies to date. However, as it is going to be a key feature of your future role the ACCA deem it to be of significance at this level.

Business Context

In this chapter we focus on the hot topic of the corporate social responsibilities organisations have towards the natural environment. We consider the impact organisations have upon the environment, where the concept of sustainability is particularly important, as it relates to whether the impact the organisation makes on the environment can be limited to what the environment can bear.

Going forward business organisations can expect to be required to formally report and audit the environmental impacts of their activities.

Overview


Social and Environmental issues
Social issues
Individuals
Communities
Infrastructure
Environmental issues
Resources
Waste
Pollution / Emissions
Sustainability
• Strong
• Weak
Costs
Audit

1 Social and environmental effects of business activity

1.1 There is growing concern about the relationship between business and the environment.

1.2 Adverse environmental events may tarnish a business' reputation. Many businesses anticipate increased legislation and controls in this area and wish to plan for them. Other businesses are motivated by efficiency and economy to reduce waste.

Lecture example 1

Classroom discussion

Required

The most serious environmental issue facing a business may be whether their activities contribute to climate change. What practical measures could a business employ to reduce such impacts?

Solution

1.3 **Environmental footprint** is a measure of the impact that a particular business's activities have upon the environment including its resource environment and pollution emissions.

1.4 Examples of factors used to determine a firm's environmental footprint include:

(a) Depletion of natural resources
(b) Noise and aesthetic impacts
(c) Residual air and water emissions
(d) Long-term waste disposal (exacerbated by excessive product packaging)
(e) Uncompensated health effects
(f) Change in the local quality of life (through for example, the impact of tourism)

2 Environmental costs

2.1 Environmental costs that arise as a result of the environmental footprint include:

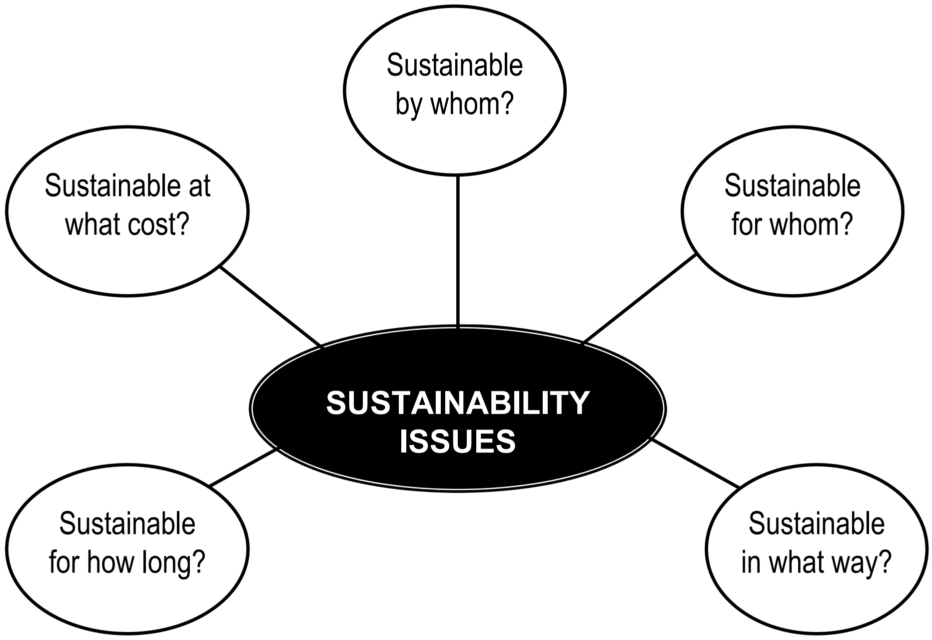
Direct and indirect environmental cost	Contingent and intangible environmental costs
Waste management	Compensation costs
Remediation costs	Risk posed by future regulatory changes (including added compliance costs)
Compliance costs	Employee health and safety, with potential litigation
Permit fees (e.g. carbon trading)	Sustainability of raw material inputs, and associated dependency on such resources
Environmental training, research and development and related maintenance	Risk of impaired assets, in terms of business value
Legal costs	Public perception and the impact on reputation, brand value, market share, etc.
Fines for non-compliance	
Environmental certification and labelling	
Natural resource inputs	
Record keeping and reporting	

2.2 Failing to take due account of the environmental impact [footprint] can have a significant impact on reported business's performance, as well as on the natural world.

3 Sustainability

3.1 **Sustainability means limiting the use of depleting resources to a level that can be replenished.**

3.2 When considering sustainability a number of questions need to be considered:



3.3 A key issue here is **generational equity,** ensuring that future generations are able to enjoy the same environmental conditions, and in social terms per capita welfare is maintained or increased.

3.4 The two approaches to the idea of sustainability relate to their supporters' views of the extent, causes and solutions. These are:

(a) **Weak sustainability** believes that the focus should be on sustaining the human species and the natural environment can be regarded as a resource. The weak sustainability viewpoint tends to dominate discussion within the Western economic viewpoint

(b) **Strong sustainability** stresses the need for harmony with the natural world; it is important to sustain all species, not just the human race. They see a requirement for fundamental change, including a change in how man perceives economic growth (and whether it is pursued at all).

The Global Reporting Initiative (GRI)

3.5 The Global Reporting Initiative is a large multi-stakeholder network of thousands of experts, in dozens of countries worldwide, who participate in working groups and governance bodies, with the aim of developing a common sustainability-reporting framework.

3.6 The GRI aims to develop transparency, accountability, reporting and sustainable development. Its vision is that reporting on economic, environmental and social importance should become as routine and comparable as financial reporting.

3.7 The GRI published revised guidelines in 2006, known as G3,

4 Full cost accounting

4.1 **Full cost accounting (FCA)** is at its simplest a system that allows current accounting and economic numbers to incorporate all potential/actual costs and benefits into the equation including environmental (and perhaps social) externalities to get the prices right.

4.2 A key problem is that we are not yet sure what a full cost price looks like. The approach used tries to achieve increasingly full costs by using a number of tiers of cost.

Tier 0	Usual costs	Basic capital and revenue costs
Tier 1	Hidden costs	Costs usually included as overheads eg costs of management systems and safety
Tier 2	Liability costs	Contingent liability costs eg fines
Tier 3	Less tangible costs	Costs of poor environmental management eg loss of goodwill of customers and suppliers, reputation risk
Tier 4	Environment focused costs	Costs that ensure that project has zero environmental effect

4.3 The **advantages** of FCA

(a) Improved information about the full extent of environmental footprint

(b) Favourable publicity if firms demonstrate that products or processes do not have significant environmental impacts.

4.4 **Disadvantages** of FCA

(a) FCA requires organisations to gather an increased amount of data, with potentially significant information-gathering costs

(e) The need to include subjective social externalities. (In economics an externality is an impact (positive or negative) on any party not involved in the economic transaction).

5 Environmental management systems

Eco-Management and Audit Scheme (EMAS)

5.1 EMAS is a voluntary scheme that emphasises targets and improvements, on-site inspections and requirements for disclosure and verification.

5.2 Requirements for EMAS registration

(a) An environmental policy containing commitments to comply with legislation and achieve continuous environmental performance improvement

(b) An on-site environmental review

(c) An environmental management system that is based on the review and the company's environmental policy

(d) Environmental audits at sites at least every three years

(e) Audit results to form the basis of setting environmental objectives and the revision of the environmental policy to achieve those objectives

(f) A public environmental statement validated by accredited environmental verifiers containing detailed disclosures about policy, management systems and performance in areas such as pollution, waste, raw material usage, energy, water and noise

ISO 14000

5.3 ISO 14000 provides a general framework on which a number of specific standards have been based (the ISO family of standards).

5.4 ISO 14001 prescribes that an environmental management system must comprise:

(a) An environmental policy statement, which should be the basis for future action. It needs therefore to be based on reliable data, and allow for the development of specific targets.

(b) Assessment of environmental aspects and legal and voluntary obligations.

(c) A management system ensuring effective monitoring and reporting on environmental compliance.

(d) Internal audits and reports to senior management.

(e) A public declaration that ISO 14001 is being complied with.

Environmental reporting

5.5 The arguments in favour of environmental reporting, promote the need for transparency and openness, disclosing all matters of concern to investors and other stakeholders. These should be generally presented in a balanced dispassionate and understandable way.

6 Social and environmental audits

6.1 **Social audit** is the process of checking whether an organisation has achieved set targets.

6.2 General social audits will involve:

(a) Establishing whether the organisation has a rationale for engaging in socially responsible activity.

(b) Identifying that all current environment programmes are congruent with the mission of the company.

(c) Assessing objectives and priorities related to these programmes

(d) Evaluating company involvement in such programmes past, present and future

6.3 An **environmental audit** is a systematic, documented, periodic and objective evaluation of how well an entity, its management and equipment are performing, with the aim of helping to safeguard the environment by facilitating management control of environmental practices and assessing compliance with entity policies and external regulations.

6.4 In practice environmental audits may cover a number of different areas including:

(a) Environmental Impact Assessments
(b) Environmental surveys
(c) Environmental SWOT analysis
(d) Environmental Quality Management (EQM)
(e) Eco-audits
(f) Eco-labelling
(g) ISO 14000
(h) Supplier audits

7 Chapter summary

Section	Topic	Summary
1	Social and Environmental Effects of Business Activity	Businesses are concerned with their social and environmental impact because of the potential effect on their reputation, because of potential costs and because of the likelihood of increased legal controls. Impact is measured in terms of footprints.
2	Environmental Costs	Tangible environmental costs cover compliance and permits, intangible costs range from impact on reputation to contingent liabilities for health costs.
3	Sustainability	Sustainability means limiting the use of resources to a level that can be replenished. Some resources are therefore inherently unsustainable. The objective of the Global Reporting Initiative is to produce reporting standards on a wide range of issues including environmental reporting
4	Full Cost Accounting	Full Cost Accounting extends the measurement of cost beyond the normal financial accounting (Tier 0) and management accounting (Tier 1) figures to include contingencies (Tier 2), intangibles (Tier 3) and purely environmental costs (Tier 4)
5	Environmental Management Systems	EMAS is a voluntary scheme based on improving targets, inspection and verification of performance. ISO 14000 provides a prescription for an environmental management system.
6	Social and Environmental Audits	Social audits usually focus on checks as to whether a company has met previously stated social policies. Environmental audits can range in scope from mandatory Environmental Impact Assessments required for many large scale projects to environmental SWOT analysis as part of wider strategic planning.

END OF CHAPTER

Answers to Lecture Examples

Chapter 1

Answer to Lecture Example 1

(a) Improved risk management. The reduction of downside risk will reduce business losses.

(b) Overall business performance is enhanced by management focusing attention on areas of critical importance.

(c) Defines clear accountability for executive decision making.

(d) It provides both an appropriate and adequate systems of internal control, which permeates the organisation from top to bottom.

(e) Best practice guidelines, applied by management, who therefore strive to improve their performance.

(f) Encourages ethical behaviour and corporate social responsibility.

(g) Safeguards the firm from misuse of business assets, both tangible and intangible.

(h) Can attract new investment, particularly in developing countries.

Answer to Lecture Example 2

(a) Profit-related/economic value-added pay: Pay or bonuses related to the size of profits or economic value-added (covered in Chapter 3).

(b) Rewarding managers with shares. This might be done when a private company 'goes public' and managers are invited to subscribe for shares in the company at an attractive offer price. In a management buy-out or buy-in (the latter involving purchase of the business by new managers; the former by existing managers), managers become joint owner-managers.

(c) Executive share option plans (ESOPs) In a share option scheme, selected employees are given a number of share options, each of which gives the holder the right after a certain date to subscribe for shares in the company at a fixed price. The value of an option will increase if the company is successful and its share price goes up, therefore giving managers an incentive to take decisions to increase the value of the company, actions congruent with wider shareholder interests.

Such measures might merely encourage management to adopt 'creative accounting' methods which will distort the reported performance of the company in the service of the managers' own ends.

(d) An alternative approach is to attempt to monitor managers' behaviour, for example by:

- establishing 'management audit' procedures,
- introducing additional reporting requirements,
- seeking assurances from managers that shareholders' interests will be foremost in their priorities.

The most significant problem with monitoring is likely to be the agency costs involved, as they may imply significant shareholder engagement with the company.

Answer to Lecture Example 3

Corporate governance reports worldwide have concentrated significantly on the roles, interests and claims of the internal and external stakeholders involved.

(a) **Directors**: The powers of directors to run the company are set out in the company's constitution or articles. Under corporate governance best practice there is a distinction between the roles of executive directors, who are involved full-time in managing the company, and the non-executive directors, who primarily focus on monitoring. However under company law in most jurisdictions the legal duties of directors apply to both executive and non-executive directors.

(b) **Employees** play a vital role in an organisation in the implementation of strategy; they need to comply with the corporate governance systems in place and adopt appropriate culture. Their commitment to the job may be considerable involving changes when taking the job (moving house), dependency if in the job for a long time (not just financial but in utilising skills that may not be portable elsewhere) and fulfilment as a human being (developing a career, entering relationships).

(c) **Suppliers**. Major suppliers will often be key stakeholders, particularly in businesses where material costs and quality are significant. Supplier co-operation is also important if organisations are trying to improve their management of assets by keeping inventory levels to a minimum; they will need to rely on suppliers for reliability of delivery. If the relationship with suppliers deteriorates because of a poor payment record, suppliers can limit or withdraw credit and charge higher rates of interest. They can also reduce their level of service, or even switch to supplying competitors.

(d) **Customers** have increasingly high expectations of the goods and services they buy, both from the private and public sectors. These include not just low costs, but value for money, quality and service support. In theory, if consumers are not happy with their purchases, they will take their business elsewhere next time. With increasingly competitive markets, consumers are able to exercise increasing levels of power over companies as individuals.

(e) **External auditors**. The external audit is one of the most important corporate governance procedures; it enables investors to have much greater confidence in the information that their agents, the directors/managers are supplying. However, the main focus of the external audit is on giving assurance that the accounts give a true and fair view. Because of the significance of the external audit, the external auditors must be independent.

(f) **Regulators**. A key interest of regulators in corporate governance is maintaining shareholders-stakeholder confidence in the information with which they are being provided.

Chapter 2

Answer to Lecture Example 1

(a) It avoids the need for inflexible legislation that companies have to comply with even though the legislation is not appropriate.

(b) It is less burdensome in terms of time and expenditure. Although governments have not been directly involved in many of the bodies that have established corporate governance practice; they clearly have a major interest and have made their views known. In many countries there are continual pressures from business for governments to 'reduce the burden of red-tape.'

(c) A principles-based approach allows companies to develop their own approach to corporate governance that is appropriate for their circumstances within the limits laid down by stock exchanges.

(d) Where principles-based approaches have been established in the form of corporate governance codes the specific recommendations that the codes make are generally enforced on a comply or explain basis. Businesses can therefore explain why they have departed from the specific provisions if they feel it is appropriate.

(e) A principles-based approach accompanied by disclosure requirements puts the emphasis on investors making up their own minds about what businesses are doing

Answer to Lecture Example 2

(a) **Increasing internationalisation and globalisation** meant that investors, and institutional investors in particular, began to invest outside their home countries. The King report in South Africa highlights the role of the free movement of capital, commenting that investors are promoting governance in their own self-interest.

(b) The **differential treatment of domestic and foreign investors**, both in terms of reporting and associated rights/dividends, also the excessive influence of majority shareholders in insider jurisdictions, caused many investors to call for parity of treatment.

(c) Issues concerning **financial reporting** were raised by many investors and were the focus of much debate and litigation. Shareholder confidence in what was being reported in many instances was eroded.

(d) The characteristics of individual countries may have a **significant influence** in the way corporate governance has developed. The King report emphasises the importance of qualities that are fundamental to the South African culture such as collectiveness, consensus, helpfulness, fairness, consultation and religious faith in the development of best practice.

An increasing number of **high profile corporate scandals** and collapses including Polly Peck International, BCCI, and Maxwell Communications Corporation prompted the development of governance codes in the early 1990s. However, the scandals since then have raised questions about further measures that may be necessary.

Answer to Lecture Example 3

A number of problems have been identified with international codes of corporate governance.

(a) International principles represent a **lowest common denominator** of general, fairly banal and meaningless principles.

(b) Any attempt to strengthen the principles will be extremely difficult because of **global differences** in legal structures, financial systems and structures of corporate ownership, culture and economic factors.

(c) As international guidance has to be based on **best practice** in a number of regimes, development will always lag behind changes in the most advanced regimes.

(d) The codes have **no legislative power**.

Chapter 3

Answer to Lecture Example 1

(a) Monitoring the chief executive officer

(b) Overseeing strategy

(c) Monitoring risks, control systems and governance

(d) Monitoring the human capital aspects of the company in regard to succession, morale, training, remuneration and so on

(e) Managing potential conflicts of interest

(f) Ensuring that there is effective communication of its strategic plans, both internally and externally

Answer to Lecture Example 2

The UK Higgs report suggests a list of the criteria that could be used to appraise the performance of a board:

(a) Performance against objectives
(b) Contribution to testing and development of strategy and setting of priorities
(c) Contribution to robust and effective risk management
(d) Contribution to development of corporate philosophy (values, ethics, social responsibilities)
(e) Appropriate composition of board and committees
(f) Responses to problems or crises
(g) Are matters reserved for the board the right ones?
(h) Are decisions delegated to managers the right ones?
(i) Internal and external communication
(j) Board fully informed of latest developments
(k) Effectiveness of board committees
(l) Quality of information
(m) Quality of feedback provided to management
(n) Adequacy of board meetings and decision-making
(o) Fulfilling legal requirements

Answer to Lecture Example 3

(a) It reflects the reality that both jobs are demanding roles.

(b) The CEO can then run the company; the chairman can run the board.

(c) The separation of roles avoids the risk of conflicts of interest.

(d) The board cannot make the CEO truly accountable for management if it is led by the CEO.

(e) Separation of the roles means that the board is more able to express its concerns effectively by providing a joint channel of reporting (the chairman) for the non-executive directors.

(f) The UK Combined Code also suggests that the CEO should not go on to become chairman of the same company. If a CEO did become chairman, the main risk is that he will interfere in matters that are the responsibility of the new CEO and thus exercise undue influence over him or her.

[Note: The UK Cadbury report recommends that if the posts were held by the same individual, there should be a strong independent element on the board with a recognised senior member. The UK Higgs report suggests that a senior independent non-executive director should be appointed who would be available to shareholders who have concerns that were not resolved through the normal channels.]

Answer to Lecture Example 4

(a) Non-executive directors should have no business, financial or other connection with the company, apart from fees and shareholdings.

(b) They should not take part in share option schemes and their service should not be pensionable, to maintain their independent status.

(c) Appointments should be for a specified term and reappointment should not be automatic. The board as a whole should decide on their nomination and selection.

(d) Procedures should exist whereby non-executive directors may take independent advice, at the company's expense if necessary.

(e) In some jurisdictions factors that impair independence are stressed, others emphasise positive qualities that promote independence. Ultimately, as the ICGN guidelines point out, all definitions come down to directors being independent-minded, which means exercising objective judgement in the best interests of the corporation whatever the consequences for the director personally.

Answer to Lecture Example 5

Advantages of multi-tier boards

(a) The clear and formal separation between the monitors and those being monitored.

(b) The supervisory/policy board has the capacity to be an effective guard against management inefficiency or worse. Its existence may act as a deterrent to fraud or irregularity in a similar way to the independent audit.

(c) The supervisory board system should take account of the needs of stakeholders other than shareholders, specifically employees, who are clearly important stakeholders in practice.

(d) The system actively encourages transparency within the company, between the boards and, through the supervisory board, to the employees and the shareholders. It also involves the shareholders and employees in the supervision and appointment of directors.

Disadvantages of multi-tier boards

(a) Confusion over authority and therefore a lack of accountability can arise with multi-tier boards. This criticism has been particularly levelled at Japanese companies where the consequence is allegedly often over-secretive procedures.

(b) The management board may restrict the information passed on to the supervisory board and the boards may only liaise infrequently.

(c) The supervisory board may not be as independent as would be wished, depending on how rigorous the appointment procedures are. In addition, members of the supervisory board can be, indeed are likely to be, shareholder representatives; this could detract from legal requirements that shareholders don't instruct directors how to manage if the supervisory board was particularly strong.

Answer to Lecture Example 6

(a) **Basic salary** will be in accordance with the terms of the directors' contract of employment, and is not related to the performance of the company or the director. Instead it is determined by the experience of the director and what other companies might be prepared to pay (the market rate).

(b) **Performance related bonuses**. Directors may be paid a cash bonus for good (generally accounting) performance. To guard against excessive payouts, some companies impose limits on bonus plans as a fixed percentage of salary or pay.

(c) **Transaction bonuses** tend to be much more controversial. Some chief executives get bonuses for acquisitions, regardless of subsequent performance, possibly indeed further bonuses for spinning off acquisitions that have not worked out.

(d) Directors may be awarded **shares** in the company with limits (a few years) on when they can be sold in return for good performance.

(e) **Share options** give directors the right to purchase shares at a specified exercise price over a specified time period in the future. If the price of the shares rises so that it exceeds the exercise price by the time the options can be exercised, the directors will be able to purchase shares at lower than their market value. [The UK Combined Code states that non-executive directors should not normally be offered share options, as options may impact upon their independence.]

(f) **Benefits in kind** could include transport (e.g. a car), health provisions, life assurance, holidays, expenses and loans. The remuneration committees should consider the benefit to the director and the cost to the company of the complete package. Also the committee should consider how the directors' package relates to the package for employees; ideally perhaps the package offered to the directors should be an extension of the package applied to the employees.

(g) **Pensions.** Many companies may pay pension contributions for directors and staff. In some cases however, there may be separate schemes available for directors at higher rates than for employees. The UK Combined Code states that as a general rule only basic salary should be pensionable. The Code emphasises that the remuneration committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.

Chapter 4

Answer to Lecture Example 1

The limitations of internal controls include:

(a) The costs of control not outweighing their benefits

(b) The potential for human error or fraud

(c) Collusion between employees

(d) The possibility of controls being by-passed or overridden by management

(e) Controls being designed to cope with routine and not non-routine transactions

(f) Controls depending on the method of data processing – they should be independent of the method of data processing

(g) Effective controls do not guarantee success. They cannot turn a poor or mediocre manager unto a good manager.

Chapter 5

Answer to Lecture Example 1

Threats to internal audit independence

(a) Involvement in systems design. If internal audit has been involved in the design of systems, it is very doubtful that they can audit what they have recommended.

(b) Over familiarity. As a result of working for the same organisation, and being involved with the same issues, internal auditors may develop close professional or personal relationships with the managers and staff they are auditing. This may well make it very difficult to achieve independence.

(c) An organisation's culture

(d) Informal networks of staff can have a big influence on individuals' attitudes to ethics.

(e) Reporting relationships. The principle that internal audit should be independent of the line management whose sphere of authority it audits ideally should extend to internal audit being independent of the finance director.

Resolving with the issues of independence

(a) The department should report to the board or to the audit committee and not to the finance director.

(b) Management should ensure staff recruited to internal audit through internal job transfer do not conduct audits on departments in which they have worked.

(c) Where internal audit staff have also been involved in designing or implementing new systems, they should not conduct post-implementation audits.

(d) Internal auditors should have appropriate scope in carrying out their responsibilities, and unrestricted access to records, assets and personnel.

(e) Rotation of staff over specific departmental audits should be implemented.

Answer to Lecture Example 2

The benefits that an effective audit committee can bring include:

(a) Improve the quality of financial reporting, by reviewing the financial statements on behalf of the board

(b) Create a climate of discipline and control, which will reduce the opportunity for fraud

(c) Enable the non-executive directors to contribute an independent judgement and play a positive role

(d) Help the finance director, by providing a forum in which he can raise issues of concern, and which he can use to get things done which might otherwise be difficult

(e) Strengthen the position of the external auditor, by providing a channel of communication and forum for issues of concern

(f) Provide a framework within which the external auditor can assert his independence in the event of a dispute with management

(g) Strengthen the position of the internal audit function, by providing a greater degree of independence from management

(h) Increase public confidence in the credibility and objectivity of financial statements.

Chapter 6

Answer to Lecture Example 1

Other factors contributing to strategic risks will include:

(a) The types of industries/markets within which the business operates

(b) The state of the economy

(c) The actions of competitors and the possibility of mergers and acquisitions

(d) The stage in a product's life cycle, higher risks in the introductory and declining stages

(e) The dependence upon inputs with fluctuating prices, e.g. wheat, oil etc

(f) The level of operating gearing – the proportion of fixed costs in total costs

(g) The flexibility of production processes to adapt to different specifications or products

(h) The organisation's research and development capacity and ability to innovate

(i) The significance of new technology

(j) Investors will be concerned with financial returns, accuracy and timeliness of information and quality of leadership

(k) Suppliers and employees will be influenced by the terms and conditions of business and employment.

(l) The organisation needs to consider whether employees have the appropriate knowledge and attitudes

(m) The level of customer service, also product safety issues, will obviously influence customers and perhaps whether the organisation is 'ethical' in matters such as marketing practice; their changing attitudes and expectations will also be influential.

Note: There may be little management can do about some of these risks, they are inherent in business activity. However, strategies such as diversification can contribute substantially to the reduction of many strategic risks.

Answer to Lecture Example 2

Financial risks include the risks relating to:

(a) Capital structure.

(b) Sufficiency of long-term capital base for the amount of trading it is doing (overtrading).

(c) Fraud and misuse of financial resources.

(d) Currency risk is the possibility of loss or gain due to future changes in exchange rates.

(e) Interest rate risk, if a firm has a significant amount of variable (floating) rate debt, interest rate movements will give rise to uncertainty about the cost of servicing this debt. Conversely, if a company uses a lot of fixed rate debt, it will lose out if interest rates begin to fall.

(f) Market risk is a risk of loss due to an adverse move in the market value of an asset – a stock, a bond, a loan, foreign exchange or a commodity – or a derivative contract linked to these assets (IAS39).

(g) Credit risk is the risk to a company from the failure of its debtors to meet their obligations on time.

(h) Liquidity risk is the risk of loss due to a mismatch between cash inflows and outflows.

(i) A misstatement of published financial information.

(j) Finance providers' risk if it provides finance for others. If it lends money, there is the risk of default on debt payments, and ultimately the risk that the borrower will become insolvent. If it invests in shares, there is a risk that it will receive low or no dividends, and share price volatility will mean that it does not receive any capital gains on the value of the shares.

Answer to Lecture Example 3

(a) Physical damage risks, with fire and water are the most serious hazard to computer systems. Destruction of data can be even more costly than the destruction of hardware.

(b) Sabotage by individuals (or groups)

(c) Data and systems integrity risk,

(d) Internet risk

  (i) Corruptions such as viruses on a single computer can spread through the network to all of the organisation's computers.

  (ii) If the organisation is linked to an external network, persons outside the company (hackers) may be able to get into the organisation's internal network, either to steal data or to damage the system.

  (iii) Employees may download inaccurate information or imperfect or virus-ridden software from an external network.

  (iv) Information transmitted from one part of an organisation to another may be intercepted. Data can be 'encrypted' (scrambled) in an attempt to make it unintelligible to eavesdroppers.

  (v) The communications link itself may break down or distort data.

(e) Human error such as entering incorrect transactions, failing to correct errors, processing the wrong files and failing to follow prescribed security procedures.

(f) Technical errors include malfunctioning hardware or software and supporting equipment such as communication equipment, normal and emergency power supplies and air conditioning units.

(g) Industrial action and the resultant disruption to normal trading activities.

Answer to Lecture Example 4

Financial Risks

There is no indication of how the expansion of the business is being financed. The company may find it hard to raise debt or to re-finance debt.

Retail businesses are prone to credit card fraud and misappropriation of cash. The company should be suspicious of many refunds on particular cards. It will have to consider the cost-benefit of controls to detect misappropriation of cash.

Retail businesses often have good short term liquidity; however this may change as more transactions are carried out using the company's store cards.

Fashion businesses are increasingly sourcing their ranges from countries like China. This may increase the exposure to foreign exchange gains and losses.

Companies like A & B suffered stock shortages in the last few months of 2005 because of EU trade restrictions on the import of goods from China.

A & B's business is likely to suffer if there is a recession in Europe and North America. They may also lose out if they are not successful in their online trading as there is a move away from the high street to online purchases.

The business may face increased costs if there is a sudden shortage in any of the raw materials needed to manufacture the products they sell, for example if there was a failure of major cotton crops.

The company has historically had few worries about credit risk. However with the extension of its financial services it has to assess the risk of people defaulting on their store cards.

The company faces the risk of its financial records being misstated because it has to manage transactions in a large network of stores.

Legal and Political Risks

The company has made much of its reputation for environmental and social integrity. Setting such high expectations increases the risk that stakeholder's perceptions of the company may fall short of expectation.

In the markets outside their home country the company has made a strategic decision to link their brand to the values of their native country. This carries the risk that the company's business may suffer if there are political problems with the home country. Customers may boycott the stores to protest against actions of A & B home government.

Technological risks

The company will need to plan for the possibility of physical damage to its computer systems particularly its EFTPOS system.

It needs to protect its systems against viruses and to ensure that its data does not fall into the wrong hands. TJX the parent company to TKMaxx lost the credit card details of millions of customers.

Health and Safety

The company will need to ensure that it has adequate controls to ensure the safety of its staff and members of the public shopping in its stores.

Environmental Risk

The company has linked its reputation to its environmental performance. This increases the potential losses the company may face if there are any adverse environmental events linked with the company.

As a clothing retailer it may wish to address issues like the use of pesticides by the suppliers of the raw materials for its clothing.

It is also likely to face harmful criticism if has not addressed issues such excess waste from packaging.

Property Risk

The company operates a large network of stores. If the company owns these buildings it will need to manage any risks to the building fabric.

Product Risk

The company needs to ensure the quality of the products it sells or it may face losses particularly if it has to recall products.

Chapter 7

No lecture examples

Chapter 8

Answer to Lecture Example 1

(a) **Personal views.** Surveys suggest that managers acknowledge the emotional satisfaction from successful risk-taking, although this is unlikely to be the most important influence on appetite. Individuals vary in their attitudes to risk and this is likely to be transferred to their roles in organisations.

(b) **Shareholders** demand a level of return that is consistent with taking a certain level of risk. Managers will respond to these expectations by viewing risk-taking as a key part of decision-making.

(c) **Organisational influences** may be important, and these are not necessarily just a response to shareholder concerns. Organisational attitudes may be influenced by significant losses in the past, changes in regulation and best practice, or even changing views of the benefits risk management can bring. Attitudes to risk will also depend on the size, structure and stage of development of the organisation.

(d) **National influences**. There is some evidence that national culture influences attitude towards risk and uncertainty. Surveys suggest that attitudes to risk vary nationally according to how much people are shielded from the consequences of adverse events.

(e) **Cultural influences**, there are four viewpoints that are key determinants in how risks is viewed.

   (i) Fatalists see themselves as having no control over their own lives and hence risk management is pointless; nothing they can do can make any difference to a situation.

   (ii) Hierarchists emphasise risk reduction through formal risk management procedures including research to establish the facts, increased regulation, and an emphasis on risk reduction, avoidance and discouraging risk-taking behaviour.

   (iii) Individualists seek to control their environment rather than let their environment control them. They will often be found in small single-person dominated organisations with less formal structures, and hence risk management too will be informal, if indeed it is considered at all.

   (iv) Egalitarians are loyal to groups but have little respect for procedures. Their preference will be for sharing of risks as widely as possible or transfer of risks to those best able to bear them.

(f) **Entrepreneurial risk** is the risk that is integral to the pursuit of business opportunities. Whatever the other influences affecting management attitudes, boards of businesses have to bear some risks if they are to succeed in business.

Answer to Lecture Example 2

(a) The biggest problems are likely to arise when a risk culture already exists but has become inappropriate and needs to be changed. Some people embrace change and thrive on it, but many resist it. There may be a variety of reasons.

   (i) Change involves the extra effort of 'unlearning' old knowledge and the learning of new knowledge.

   (ii) Self-interest may be a factor: a new procedure may entail the involvement of another person or department and be seen as an erosion of power.

   (iii) People may misunderstand the nature of the change.

   (iv) People may simply mistrust management.

   (v) They may not agree that the change is needed.

(b) Resistance could be overcome by:

(i) Coercive methods sometimes are necessary particularly when handling short-term issues.

(ii) Acquiring the services of a 'change agent' to champion the change process by delivering the project in a sensitive but effective manner.

(iii) The use of positive incentives, with rewards aligned to actions that promote the risk awareness practices and behaviours.

(iv) A suitable organisation structure that supports the new operating framework and culture.

(v) An environment that will not apportion blame to mistakes made by staff.

(vi) Persuading key influencers to buy in to the change as a first priority.

(vii) Adequate resources (time, information, etc) to apply the new working practices alongside their existing workload.

(viii) Providing a clear and unambiguous statement of risk policy and strategy, which is distributed to all managers and staff, providing guidance on all matters pertaining to risk management in the organisation.

Chapter 9

Answer to Lecture Example 1

Directors will receive control information from the following range of sources:

(a) Directors will receive reports from the internal audit committee and risk committee.

(b) Regular visits by the directors to operations may yield valuable insights and should help the directors understand the context in which controls are currently operating.

(c) There should be systems in place for all staff with supervisory responsibilities to report on a regular basis to senior managers, and senior managers in turn to report regularly to directors.

(d) Organisational functions that have a key role to play in internal control systems must report on a regular basis to the board and senior management.

(e) The board should receive regular reports on certain activities and projects, e.g. major developments in computerised systems.

(f) The board should obtain evidence to confirm that control weaknesses that have previously been identified have been resolved. When it has been agreed that action should be taken to deal with problems, this should include timescale for action and also reporting that the actions have been implemented.

(g) The board should receive confirmation as a matter of course that necessary checks on the operation of the controls have been carried out satisfactorily and that the results have been clearly reported.

(h) Exception reports highlighting variances in budgeting systems, performance measures, quality targets and planning systems are an important part of the information that management receives

(i) Materiality
(ii) Controllability
(iii) Variance trend
(iv) Cost
(v) Interrelationship of variances

(i) Customer responses, particularly complaints, are important evidence for the board to consider, particularly as regards how controls ensure the quality of output.

Answer to Lecture Example 2

(a) Senior management demonstrate their own commitment to mitigating risk.

(b) Build warning mechanisms into existing information systems rather than develop separate risk reporting systems.

(c) Communicate policies that cover the following areas of business activity, which have risk management implicitly associated:

   (i) Customer relations
   (ii) Service levels for both internal and outsourced activities
   (iii) Health, safety and environmental protection
   (iv) Security of assets
   (v) business continuity
   (vi) Expenditure and cost control
   (vii) Accounting, financial and other reporting

(d) Dissemination of the risk management policy and codes of conduct, also key business objectives and internal control

(e) Clear channels of communication for reporting breaches and other improprieties

(f) Training can be particularly useful in emphasising to staff the importance of different types of control (preventative, detective etc) and also the need for some controls to assist staff development, but others to enforce sanctions particularly in cases of dishonesty or negligence.

Chapter 10

Answer to Lecture Example 1

Merits

(a) Relativism highlights differences in cultural beliefs; for example all cultures may say that it is wrong to kill innocents, but different cultures may have different beliefs about who innocents actually are.

(b) Whereas differing absolutist beliefs tend to result in moral conflict between people; relativist ethics should act to resolve such conflicts.

(c) In the modern business environment where the global economy prevails business is conducted in many different countries (and cultures), adopting a relativist approach presumes more flexibility and thereby greater success.

(d) Relativism highlights our cognitive bias in observing with our senses (we see only what we know and understand) and our notational bias (what we measure without using our senses is subject to the bias of the measurement methods used).

Demerits

(a) Strong relativism is a based on a fundamental contradiction; the statement that 'All statements are relative' is itself an absolute, non-relative statement. However, it is possible to argue that some universal truths exist, but deny other supposedly objective truths.

(b) A common criticism of relativism is that it leads to a philosophy of 'anything goes', denying the existence of morality and permitting activities that are harmful to others.

(c) Some critics have argued for the existence of natural absolute moral laws.

(d) Ideas such as objectivity and final truth do have value.

(e) If it's valid to say that everyone's differing opinions are right, then it's equally valid to say that everyone's differing opinions are wrong. This can lead to immense confusion and disagreement, and breakdown in communication and trust.

Chapter 11

Answer to Lecture Example 1

(a) Clear commitment from management
(b) Recruitment and selection policies and procedures
(c) Careful induction
(d) Staff training and workshops
(e) Terms contained with contracts of employment
(f) Objectives setting (Management by Objectives)
(g) Staff appraisal and reporting systems
(h) Remuneration and reward schemes
(i) Sanctions for clear breach of ethical rules
(j) Ethical (internal) audit

Answer to Lecture Example 2

Examples of safeguards in the assurance client/firm's own systems and procedures:

(a) Involving an additional professional accountant to review the work done or otherwise advise as necessary

(b) Consulting an independent third party, such as a committee of independent directors, a professional regulatory body or another professional accountant

(c) Rotating senior personnel

(d) Discussing ethical issues with those in charge of client governance

(e) Disclosing to those charged with governance the nature of services provided and extent of fees charged

(f) Involving another firm to perform or even repeat part of the engagement

Answer to Lecture Example 3

It appears that at a critical time for the firm, employees are ignoring internal control systems.

Business issues

(a) Banks may take action to protect their interests, which could liquidity problems to the firm (possibly even make it insolvent).

(b) A valuable sale may be lost, with the resultant impact on financial performance and a lost opportunity to enter this lucrative market.

(c) This may be just the tip of the iceberg, in term of control weakness.

(d) There is a need for a comprehensive risk assessment and thorough internal audit of all internal control systems.

(e) Questions must be asked about the effectiveness of Mary Flanagan, if this practice has been going on for some time but internal audit have failed to identify it before.

(f) The bank has a right to know about control weaknesses, and this could have a detrimental impact on the firm's credit rating going forward.

(g) Material breaches of control and resultant losses must be accounted for and reported to the shareholders.

Ethical issues

(a) Ascertain the facts of the case, and take the emotion out of the situation (remember there were two expense claims submitted so the other party could have been party to the fraud).

(b) Determine what issues have arisen (business, ethical, legal).

(c) Consider all of the possible actions that could be taken to resolve the situation now and in the future.

(d) Appraise the likely consequences of each action on the firm, its employees and all other stakeholders.

(e) Consider any underlying ethical principles (fairness, integrity, openness, professional behaviour).

(f) Agree the most appropriate course of action, communicate it to all parties affected, implement the programme and monitor its effectiveness.

Chapter 12

Answer to Lecture Example 1

Companies to reduce carbon dioxide emissions by:

(a) Increasing the energy efficiency of buildings and factories

(b) Taking advantage of recent advances in combined heat and power to increase energy efficiency and lower energy costs

(c) Purchasing power generated from renewable energy sources [Johnson & Johnson, 30% of whose total US energy use is from green power sources such as wind power, on-site solar, low-impact hydro, renewable energy sources]

(d) Integrating next-generation efficiency measures into the design of new buildings, factories and products [IBM, whose energy savings methods include installing motion detectors for lighting in bathrooms and copier rooms, rebalancing heating and lighting systems and resizing high purity water pumping systems in semi-conductor manufacturing lines]

(e) Integrating energy and environmental efficiency into building, product and process design

(f) Optimising existing manufacturing processes

(g) Educating employees, customer base and supply chain to help take advantage of best practices for greenhouse gas mitigation (Polaroid's Facilities organisation now requires each employee to identify energy-saving projects as part of their performance evaluation).

END OF ANSWERS TO LECTURE EXAMPLES

Question and Answer bank

Index to Question and Answer bank

Questions

1 Frameworks, codes and systems

Required

(a) Describe, with brief comments, the factors, which influenced the introduction of the various frameworks, codes and systems of corporate governance. **(10 marks)**

(b) Describe how the introduction of each of the successive frameworks, codes and systems of corporate governance has contributed to better corporate governance. **(15 marks)**

(Total: 25 marks)

2 Nerium Engineering

Nerium Engineering plc is a recently listed company that has just appointed a new, non-executive director to its main board of directors. At the first board meeting that the non-executive director attended, he was asked to become a member of the audit committee. This committee has only just been established and its terms of reference have yet to be finally agreed. The non-executive director is unsure what such a role might involve and, as a qualified engineer without a detailed understanding of finance, he is also unsure as to whether he is the right person for such a committee. He has, therefore, written to you for advice.

Required

Write a report to the non-executive director setting out the possible role and responsibilities of the audit committee and the main qualities that a member of such a committee should possess. **(25 marks)**

3 Non-executive directors

It is a principle of corporate governance that the board of directors should be able to exercise an objective judgement on the company's affairs. However, it is recognised that potential conflicts of interest can arise between the owners of a company and its management. As a means of dealing with the potential conflicts of interest, it was recommended by the Cadbury Committee in the UK that the boards of companies with a London Stock Exchange listing should appoint a minimum number of non-executive directors (NEDs). A distinction was also made between independent and non-independent non-executive directors.

A variety of criticisms have been made of the system of NEDs. These include the argument that many non-executives are executive directors of other major companies, which restricts their willingness to speak out on the company's affairs. NEDs have also been criticised for holding a non-executive post with too many companies, sometimes five or even more.

In the UK, some criticism has also been voiced against the growing practice of paying NEDs partly in shares or share options of the company.

Required

(a) Explain the distinction between independent and non-independent NEDs. **(7 marks)**

(b) What are the main areas for a potential conflict of interest between the shareholders of a company and the executive directors? Explain how the use of non-executive directors should help to deal with this problem. **(11 marks)**

(c) In your view, what might be the objections to paying NEDs in shares or share options of the company, and do you agree with those objections? **(7 marks)**

(Total: 25 marks)

4 Board of directors

Required

You are required to write a report to the board of directors of a new company, which outlines the following areas.

(a) The responsibilities of the chairman of the board

(b) The role of the non-executive directors

(c) The role of the remuneration committee

(d) The role of the nomination committee **(25 marks)**

5 Caius plc

Caius plc is seeking a listing on the London Stock Exchange. The directors of the company are aware that certain listed companies have attracted considerable criticism in recent years over directors' pay and conditions. There have been claims in the media that the pay and conditions of some directors have been far too generous and that the remuneration policies adopted by some companies have been far from transparent. The directors of Caius plc are keen to ensure that, if the bid for a listing is successful, all aspects relating to their pay and conditions must be in line with best practice.

Required

Write a report to the directors of Caius plc set out the policies and frameworks that should be adopted by the company to ensure that directors' pay and conditions are fair and transparent. **(25 marks)**

6 Audit process

The audit process is an important element of corporate governance.

Required

(a) Describe the external audit process and internal audit process and discuss the role of each type of audit in contributing towards an effective system of corporate governance. **(10 marks)**

(b) Briefly discuss the relationship between the two types of audit. **(3 marks)**

(Total: 13 marks)

7 Types of risk

Required

Define the main types of risks that a company faces, and explain how codes of corporate governance can assist in managing these on a day-to-day basis. **(25 marks)**

8 COSO Framework

Required

(a) The COSO *Enterprise Risk Managemen*t Framework says that, having assessed relevant risks; management should determine how it would respond. Responses include risk avoidance, reduction, sharing, and acceptance. Give brief examples of each of these responses.

(10 marks)

(b) Management should identify control activities needed to help ensure that risk responses are carried out properly and in a timely manner. Describe some examples of possible control activities. **(15 marks)**

(Total: 25 marks)

9 Ethical considerations

You were appointed financial controller of a firm of builders' merchants almost a year ago, with the prospect of becoming finance director if you performed well.

The problem customer

An old-established customer, a contractor, X Ltd, which has expanded to take on a very large contract, is causing problems with delayed payments. X Ltd is a family firm, largely owned by its Managing Director, Y.

Following a discussion at a management meeting, the sales director and a member of your staff visited the customer with instructions to 'try and resolve the matter of delayed payments'.

The meeting

At the meeting, the sales director took the lead, having known Y for many years. Y provided the last annual accounts and the latest management accounts and contract accounts. This one large contract that X Ltd had undertaken represents some 70% of its current activity.

If all, or almost all, suppliers allow additional credit for material, and X Ltd uses its very limited remaining bank facilities to pay the workforce, Y thinks the company should be able to complete the next stage of the contract, get the architect to certify the work has been completed, and obtain a progress payment. This would enable X Ltd to pay suppliers, get more materials, and finish the contract. However, Y considers the company will make a significant loss on the contract and will only be able to trade on a much-reduced scale thereafter.

The sales director suggested, and Y agreed, an arrangement by which Y would make a payment from personal funds, against which your company would release materials to X Ltd. When it receives the progress payment X Ltd will pay your company from its company's funds and reduce the amount owing to well within normal terms. Your company will then repay Y the personal funds he has paid.

It was agreed that this arrangement should be discussed and agreed with your managing director in the morning.

After the meeting

On his return, the sales director commented that this sort of arrangement was probably the only way of getting any money back - if X Ltd went into liquidation nothing would be recovered.

Later you received a telephone message that Z, the finance director of another firm of builders' merchants and whom you know through ACCA branch meetings, has asked you to telephone urgently regarding the credit status of X Ltd.

Required

Write a report to your managing director explaining the issues involved and recommending the action to be taken on the account and on the telephone message. **(25 marks)**

10 Corporate citizenship

Required

Write a report to the directors of a UK public limited company explaining the following aspects of corporate citizenship.

(a) The concept of corporate citizenship.

(b) Ways in which social and environmental issues may affect companies.

(c) Ethical issues that a board of directors might face. **(25 marks)**

END OF QUESTION BANK

Answers

1 Frameworks, codes and systems

(a) In recent years a number of factors have influenced the introduction of a variety of frameworks, codes and systems of corporate governance throughout the world. The factors are discussed below:

(i) One of the factors giving rise to the pressure for better corporate governance was concern that some large companies were not providing fair accounts, with profits and asset values being, in some cases, artificially inflated. In the late 1980s there were a number of well-publicised corporate failures, which were unexpected, as the audited financial statements had given no indication of such problems. There was a view that the external auditors were unable to perform their function properly perhaps because a powerful or unscrupulous chief executive could keep information away from them.

(ii) There have also been criticisms that the external auditors of a company are not always as independent as they should be or as the shareholders believe them to be. This was often the case due to the fact that the auditors relied on the company not just for the audit fee but also for substantial fees for other consultancy work throughout the year.

(iii) Allied to these concerns were concerns that some large companies were being run for the benefit of the directors of the companies rather than for the shareholders. These concerns raised questions about the conflict of interest between the board of directors and the shareholders and there was particular concern about too much power being in the hands of one individual or a small number of individuals. This was particularly the case where one powerful individual held the posts of both chairman and chief executive and where boards of directors lacked balance.

(iv) There was also an issue with directors' remuneration, which was often viewed, as excessive whether the company was only performing no differently from an average company or indeed was performing badly.

(v) In the light of many corporate failures, concern was also expressed about the board's knowledge and handling of the risks that faced the business and of the adequacy of internal control systems within companies.

(vi) As there was a trend towards global investment many large institutions, particularly in the US and also in the UK, were seeking to invest substantial funds in companies in other countries. In many instances there were concerns about the lack of shareholder rights and of disregard for minority shareholders rights shown by major shareholders or the boards of these companies.

(b) In the UK the Principles of Good Governance have now been brought together in the voluntary Combined Code.

This Code has stemmed from a number of other codes, reports and frameworks:

- The Cadbury Code on the financial aspects of corporate governance
- The Greenbury Committee report on directors' remuneration
- The Hampel Committee report on corporate governance
- The Turnbull report on internal control and financial reporting
- The Smith guidance on audit committees
- The Higgs review of the role and effectiveness of non-executive directors, followed by the Tyson report on the recruitment and development of non-executive directors

The Financial Reporting Council published the latest version of the combined Code in July 2003. The main requirements of the Combined Code have attempted to address many of the concerns, which led to these successive frameworks, codes and systems of corporate governance.

Here are some examples.

(i) The concerns regarding the board of directors and directors' powers are central to the Combined Code. Every listed company should be headed by an effective board, which should lead and control the company. The two key tasks at the top of every listed company are the running of the board, and the executive responsibility of the running of the company.

(ii) The board should include a balance of executive and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board's decision making. It is recommended that non-executive directors should comprise at least *half* the board.

(iii) There should be formal and transparent procedures for the appointment of new directors to the board and all directors should be required to submit themselves for re-election at regular intervals and at least every three years.

(iv) The level of remuneration paid to directors should be sufficient to attract *and* retain the directors needed to run the company successfully but companies should avoid paying more than is necessary for this purpose. A proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance. The board should set up a remuneration committee of independent non-executive directors who will devise schemes of remuneration, which will be recommended to the board.

(v) The board should present balanced and understandable assessment of the company's position and prospects. The directors should explain their responsibility for preparing the accounts and there should be a statement from the auditors about their reporting responsibilities.

(vi) The board should maintain a sound system of internal control to safeguard the shareholders' investment and the company's assets. The directors should, at least annually, conduct a review of the effectiveness of the systems of internal controls and should report to the shareholders that they have done this. The review should cover all controls including financial, operational and compliance controls and risk management. Companies who do not have an internal audit function should from time to time review the need for one.

(vii) The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors. The audit committee should be made up of at least three non-executive directors and this committee's duties include keeping under review the scope and results of the audit and its cost effectiveness and the independence and objectivity of the auditors. Where the auditors also supply a substantial volume of non-audit services to the company the committee should keep the nature and extent of such services under review.

(viii) Companies should be ready to enter into a dialogue with institutional shareholders based on the mutual understanding of objectives. Boards should use the AGM to communicate with private investors and to encourage their participation.

2 Nerium Engineering

REPORT

To: Non-executive director
From: Accountant
Date: XX.XX.XXXX
Subject: Audit committee

You have written to me for advice about the role and responsibilities of an audit committee and the main qualities that a member of that committee should possess. The views below summarise the main points of the Financial Reporting Council's *Combined Code on Corporate Governance* and related guidance.

Role and responsibilities

One of the main roles of the audit committee is to monitor the integrity of the financial statements of the company. This will mean that the audit committee should review the significant financial reporting issues and judgements made in connection with the preparation of the various financial statements that are prepared by the company. The audit committee should also review the clarity and completeness of disclosures in the financial statements. Where the audit committee is not satisfied with any aspect of the financial reporting by the company then this should be reported to the board of directors.

The audit committee should review the company's internal financial control system and, unless addressed by a separate risk committee or by the board itself, risk management systems. The audit committee should assess the scope and effectiveness of the systems established by management to identify, assess, manage and monitor financial and non-financial risks.

The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting, financial control or any other matters – commonly known as whistle-blowing.

The audit committee also has responsibilities for the **internal audit** function and should monitor and review the effectiveness of the company's internal audit function. If there is no internal audit function, the audit committee should consider whether there is a need for one each year and make a recommendation to the board.

In general terms the audit committee is responsible for the overseeing of the company's **relations with the external auditor**. This will include the following aspects:

- The audit committee has primary responsibility for making recommendation on the **appointment, reappointment and removal** of the external auditors.
- The audit committee should assess the **qualification, expertise and resources, effectiveness and independence** of the external auditors annually.
- The audit committee should approve the **terms of engagement and the remuneration** to be paid to the external auditor in respect of audit services provided.
- The audit committee must also develop and recommend to the board the company's policy in relation to the provision of **non-audit services** by the external auditor. The objective here should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity.

Wherever the audit committee's monitoring and review activities reveal cause for concern or scope for improvement, it should make recommendations to the board of directors on action needed to address the issue or to make improvements.

Main qualities that a member of the audit committee should possess

The main qualities that a member of the audit committee should possess are a harder question to deal with as this will differ for different types of organisation but I can give you some general guidance.

- At least **three** members of the committee should be **independent non-executive directors**.
- At least **one** member of the audit committee should have significant, recent and relevant **financial experience** for example as an auditor or finance director of a listed company. Ideally, this person should have a relevant **professional qualification**.
- In general, given the role and responsibilities of the audit committee there is a need for some degree of **financial literacy** amongst the other members of the audit committee. This will vary according to the nature of the company, but experience of corporate financial matters will normally be required.
- Individual members of the audit committee should have an **overview of the company's business** and be able to identify the main business and financial dynamics and risks.

The Smith guidance on audit committees recommends that new audit committee members are given an **induction programme** and that all members receive **training** on an on-going basis.

3 Non-executive directors

(a) Non-independent NEDs

A NED is not independent if he or she is on the board representing the interests of a major shareholder, because the views given by the director will be made in the best interests of that shareholder. Similarly it is debateable whether a director is independent when he or she has a close relationship with the company or any other executive director. For example a former chief executive of the company might be given a non-executive role after retirement. He would not be independent.

Independent NEDs

In contrast an independent NED is a person who has no connection with the company other than as a non-executive director, and who should be able to give an independent opinion on the affairs of the company, without influence form any other director or shareholder.

(b) Conflicts of interest

A potential conflict of interest occurs when the executive director or senior management of a company might be inclined to take decisions that would not be in the interests of the company’s shareholders. Although there are several areas where a conflict of interest could arise, the major problem areas are those of remuneration of the directors and senior managers, financial reporting and nominations of new board members.

Remuneration

If executive directors are allowed to decide their own remuneration, they could be inclined to pay themselves as much as possible, without having to hold themselves to account or justify their high pay. Where incentive schemes are in place, there is a risk that incentive schemes devised by the executive directors for themselves will be linked to achieving performance targets that are not necessarily in the shareholders’ interests. For example rewarding directors with a bonus for achieving profit growth is of no value to shareholders if the result is higher business risk and a lower share price.

Remuneration Committee

Corporate governance in may countries, such as the UK’s Combined Code, calls for a remuneration committee of the board to be established to decide on directors’ pay, including incentive schemes, and for this committee to comprise at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors.

The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The NEDs should in principle, be able to devise fair remuneration packages that include an incentive element, in which the performance targets bring the objectives of the executive directors more into line with those of he shareholders.

Financial Reporting

A second potential area for conflict of interest is financial reporting. The executive directors might be tempted to window dress the results if the company, in order to present the financial results in a way that reflects better on themselves and their achievements.

Audit Committee

There should be an audit committee of the board, consisting of non-executive directors, whose task should be to consider issues relating to financial reporting and financial control systems. This committee should be responsible for maintaining regular liaison with the external auditors. The Combined Code says that the audit committee should comprise at least three or in the case of small companies, two members, who should all be independent NEDs. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

Nominations to the board

A third potential area for conflict is nominations of new board members. A powerful chairman or chief executive could be tempted to appoint their supporters or 'yes' men to the board, and so strengthen their position on the board. The combined code recommends that there should be a nominations committee of the board manned by NEDs.

Other areas

Other areas of potential conflict of interest can be identified, such as succession planning, and the board's decisions on making acquisitions or in preparing defences against a takeover bid. In each of these areas NEDs should be able to provide a counter balance to the self –interested views f executive directors.

(c) Share Payments

In many companies, NEDs receive a fixed cash payment for their services, without any incentives. However some companies pay their NEDs in shares.

They would argue that the more equity the NEDs hold, the more likely they will be to look at issues from the point of view of the shareholders. There is a risk that a NED holding shares could be more concerned with short-term movements in the share price and the opportunity of making a short term profit from selling their shares. However, a suitable precaution against this could be to obtain the agreement of a NED not to sell his or her shares until after leaving the board.

Share Options

The argument that NEDs should be rewarded with share options is more contentious, but it has been widely practised in the UK and is even more common in the US. The argument against rewarding NEDs with share options is that this form of remuneration could align the interests of the NEDs more closely with the executive directors, who also hold share options. NEDs should give independent advice, and it can be argued that it is therefore not appropriate to incentivise them in the same way as the executives.

The Combined Code points out that holding of share options could be relevant to the determination of a non-executive director's independence. It states that remuneration for non-executive directors should not include share options. If, exceptionally, options are granted, shareholder approval should be sought in advance and any share acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board.

4 Board of directors

REPORT

To: Board of directors
From: Consultant
Date: December X4
Subject: Board of directors and committees

Chairman

The Combined Code on Corporate Governance states that there should be a clear division between the chief executive of the company, who has executive responsibility for running the company's business, and the chairman of the board of directors who is responsible for running the board.

The main roles of the chairman should be to:

- Run the board and set its agenda
- Ensure that all members of the board receive accurate, timely and relevant information
- Encourage the active participation of all members of the board
- Ensure that adequate time is allowed for the discussion of complex or contentious issues
- Ensure that the performance of individual directors and the board as a whole, together with its committees, are evaluated at least once a year
- Ensure that there is a suitable induction programme for new directors
- Identify any development needs of individual directors
- Ensure effective communication with shareholders and major investors

Non-executive directors

The board should include a balance of executive and non-executive directors and the role of the non-executive directors should include the following elements.

- Being independent in judgement and possessing an inquiring mind
- Being well informed about the company and the environment within which it operates
- Having a strong command of issues relevant to the business
- Constructively challenging proposals on strategy and helping to develop such proposals
- Scrutinising the performance of management and monitoring reports on that performance
- Ensuring that sufficient, accurate, clear and timely information is provided to the board in advance of meetings
- Satisfying themselves of the integrity of the financial controls and information
- Satisfying themselves that the risk management systems are robust and defensible
- Determining appropriate levels of remuneration for executive directors
- Playing an important role in the appointment and removal of directors and in succession planning
- Understanding the views of major investors

Remuneration committee

The remuneration committee should be made up of non-executive directors as it is responsible for setting the remuneration for all executive directors, the chairman and the company secretary.

As well as this basic responsibility the remuneration committee has other duties.

- To determine targets for any performance related pay schemes
- To determine the policy for pension arrangements for executive directors
- To ensure that any contractual terms on termination and payments made are fair both to the company and the individual
- To determine the total individual remuneration package for each executive director including bonuses, incentive payments and share options
- To agree the policy for authorising expense claims from the chief executive and chairman
- To ensure that all required disclosures for remuneration matters are fulfilled

Nomination committee

The Combined Code requires that there should be formal, rigorous and transparent procedures for the appointment of new directors to the board. The nomination committee, made up of a majority of independent non-executive directors, can carry out this role. The main duties of this committee are to:

- Evaluate the current balance of skills, knowledge and experience on the board and with this in mind to prepare a description of the role and capabilities required for a particular appointment
- Consider candidates from a wide range of backgrounds
- Review the time required from a non-executive director annually
- Assess whether the non-executive directors are spending enough time to fulfil their duties
- Consider succession planning and in particular what skills and expertise are needed, given the challenges and opportunities facing the company
- Prepare a statement for the annual report including the process used for appointments and explains if external advice or advertising has been used. The statement should also state the membership of the committee, and the number of committee meetings attended over the year.

5 Caius plc

Tutor's note. A good guideline for this type of question would be the key points relating to directors remuneration from the Combined Code. This will give you most of the key areas that require to be discussed.

To: Board of Directors of Caius plc
From: Accountant
Date: X–X–XX
Subject: Directors' pay and conditions

In order to ensure that directors' pay and conditions are fair and transparent the company should adopt the following policies and frameworks.

Level and make-up of remuneration

The level of remuneration offered to directors should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully. However, a company should avoid paying more than is strictly necessary for this purpose. The levels of pay offered by other similar companies can be considered but such comparisons should be used with caution.

A significant proportion of executive directors' remuneration should be structured so as to link their interests with those of the shareholders and give the directors keen incentives to perform to the highest levels. Therefore, incentive schemes are acceptable but they must always be related to performance and they must be geared to the long term rather than the short term. Where incentive schemes are used the amount paid to the directors should be based upon them meeting or exceeding clearly defined targets.

Service contracts and compensation

Service contracts for directors are necessary but there must be a balance between the directors' needs and the interests of the shareholders. In general terms notice periods under contracts should be set at one year or less. The board must be prepared to dismiss a director for poor performance and much thought should be given to compensation commitments. The aim should be to avoid being seen to reward poor performance by excessive compensation payments and the board should take a robust line on reducing compensation to reflect a departing director's obligations to mitigate loss.

Remuneration committee

The board should appoint a remuneration committee made up entirely of independent non-executive directors. The aim of this is to ensure that there is a formal and transparent procedure for developing policy on executive remuneration and for the remuneration packages of individual directors. Most importantly no director should be involved in deciding his or her own remuneration.

Communication with shareholders

The remuneration committee should enter into communication with major shareholders about directors' remuneration. Shareholders should be invited specifically to approve all new long-term incentive schemes and significant changes to existing schemes. In the annual report of the company there should be a report on the remuneration policy and details of the remuneration of each director. The chairman of the remuneration committee should also attend the AGM and be prepared to answer any questions from shareholders relating to directors' remuneration.

6 Audit process

(a) The external audit process must demonstrate whether the financial statements show a "true and fair view" of the financial position and performance of the company. The external auditors must also report as to whether the financial statements have been prepared in accordance with relevant statute and whether certain specifics have been complied with:

- The company has kept proper accounting records
- The auditors have received all of the information and explanations required to carry out their audit
- The Directors' Report is consistent with the financial statements
- Information required by regulatory bodies has been disclosed.

The report to the shareholders by the external auditor is in the form of an opinion as to whether the accounts show a true and fair view in the audit report. An unqualified opinion should give shareholders and other users of the financial statements confidence in those financial statements but it is not a guarantee from the auditors that the financial statements are totally correct.

During the course of the external audit the auditors will consider and test the internal accounting systems of the company and make recommendations for improvements. However there is little

else that directly contributes towards the effective system of corporate governance as the auditor is not required to consider whether the statements of the directors regarding internal controls are comprehensive or comment on the effectiveness of the company's corporate governance procedures or risk procedures.

The internal audit function is not a legal requirement, but the board of directors may set up an internal audit department after considering the costs and benefits. The work of internal auditors is not set out in law but is decided upon by the board of directors or senior management. The work of the internal audit function will therefore vary from company to company, but the following are typical areas that the internal audit function may be required to consider.

- Testing and reporting on the internal control systems of the organisation
- Reviewing the adequacy of accounting and financial information
- Considering the effectiveness of risk management and risks control processes – identifying weaknesses and recommending improvements
- Considering compliance procedures
- Identifying weaknesses in procedures and systems and recommending improvements
- Performing one-off projects determined by management

As the remit of the internal audit function is as wide as is necessary then this can be a valuable resource to management, contributing towards an effective system of corporate governance.

(b) When the external auditors are carrying out their audit they will expect full co-operation from the internal auditors. The internal auditors should ensure that the accounting and internal control systems are operating satisfactorily but the external auditor will test those systems independently.

The external auditors will not tend to rely on the work of the internal auditors in general terms but the work on systems, controls and procedures that have been carried out by the internal audit function will be of some assistance to the external auditors in their role.

7 Types of risk

There are many different types of risk faced by commercial organisations, particularly those with international activities. They may be categorised under the following headings:

- General business risk
- Trading risk
- Cultural, country and political risk
- Currency (foreign exchange) risk
- Interest-rate risk
- Technological risk
- Fraud risk

General business risk

Business risk may be defined as the potential volatility of profits caused by the nature and type of the business operations involved.

Factors contributing to business risk will include:

- The type of industries/markets within which the business operates – the extent to which sales are vulnerable to changes in fashion, technology etc
- The state of the economy
- The actions of competitors
- The actions of unions or impact of government legislation

- The stage in a product's life cycle, with high risks in the introductory and declining stages
- The dependence upon inputs with fluctuating prices, e.g. wheat, oil etc
- The level of operating gearing – the proportion of fixed costs in total costs – the higher the level, the greater sales need to be made to break even
- The flexibility of production processes to adapt to different specifications or products

Trading risks

Both domestic and international traders will face trading risks, although those faced by the latter will generally be greater due to the increased distances and times involved. The types of trading risk include:

- *Physical risk* – the risk of goods being lost or stolen in transit, or the documents accompanying the goods going astray
- C*redit risk* – the possibility of payment default by the customer. This is discussed further below.
- *Trade risk* – the risk of the customer refusing to accept the goods on delivery (due to sub-standard/ inappropriate goods or other reasons), or the cancellation of the order in transit
- *Liquidity risk* – the inability to finance the credit

Cultural, country and political risk

Where a business trades with, or invests in, a foreign country *cultural risk* is introduced by the existence of different customs, laws and language. Communication between parties can be hindered, and potential deals put into jeopardy by ignorance of the expected manner in which such transactions should be conducted. *Country risk* is the risk associated with undertaking transactions with, or holding assets in, a particular country. Sources of risk might be political, economic or regulatory instability affecting overseas taxation, repatriation of profits, nationalisation, currency instability etc. *Political risk* is the risk that political action (exchange controls, tax changes, pricing regulations etc) will affect the position and value of a company.

Currency risk

Currency risk is the possibility of loss or gain due to future changes in exchange rates. When a firm trades with an overseas supplier or customer, and the invoice is in the overseas currency, it will expose itself to exchange rate or currency risk. Movements in the foreign exchange rates will create risk in the settlement of the debt – i.e. the final amount payable/receivable in the home currency will be uncertain at the time of entering into the transaction.

Investment in a foreign country or borrowing in a foreign currency will also carry this risk.

Interest rate risk

As with foreign exchange rates, future interest rates cannot be easily predicted. If a firm has a significant amount of variable (floating)-rate debt, interest rate movements will give rise to uncertainty about the cost of servicing this debt.

Conversely, if a company uses a lot of fixed-rate debt, it will lose out if interest rates begin to fall.

Technological risk

All businesses depend to some extent on technology, either in the support of its business activities (e.g. the computers used by the accounts, stores and treasury departments), or more directly in its production or marketing activities.

As technology evolves and develops, firms can find themselves using out of date equipment and marketing methods, which may leave them at a **competitive disadvantage**. Products in a high-tech industry have very short life cycles, and a firm must recognise and plan for continual replacement and upgrading of products if it is not to lose market share.

Fraud risk

All businesses run the risk of loss through the fraudulent activities of its employees, including management.

How the codes of corporate governance can assist in managing the risks

Corporate governance is concerned with the control and influence exerted over a company's operations and its employees by the decisions of top management, usually the board of directors.

The codes of corporate governance are guidelines and recommendations developed over a number of years by various committees and researchers (Cadbury, Greenbury, Hampel, Higgs, and Smith) and now incorporated in the UK into the Combined Code published in July 2003 by the Financial Reporting Council.

A significant element of the Code is concerned with the way internal controls are implemented and reviewed in order that such risks as those outlined above would be managed. The code includes the **Turnbull report** (*Internal Control: Guidance for Directors on the Combined Code*).

The Turnbull report included recommendations that:

- Management should **identify** and **evaluate** the risks to which they will be exposed in the achievement of their corporate objectives. These will include both the traditional areas of risk discussed above, but also those increasingly arising from intangible assets, such as reputation and branding.
- Risk control should be **embedded in the culture and processes of the business**, rather than being the subject of a completely separate management system. Each person in the organisation should be aware of, and manage, the significant risks related to the tasks they perform.
- Directors should continually review and monitor risk control issues. It should regularly review **reports on internal control** from line managers and, where appropriate, from internal auditors and other specialists.
- **Regular discussion** of risk and control issues at board meetings should be encouraged.
- **Risk analysis and assessment** should form part of the evaluation of every major capital investment or proposed acquisition.
- **Financial risk analysis** will very much depend upon commercial judgement, but the following questions may be used as a framework for the assessment of their impact on company value:
  - What is the effect on present and future cash flow?
  - What is the effect on the underlying present and future profitability of the business?
  - What is the effect on the underlying present and future liquidity and value of assets employed in the business?
  - What is the effect on the present and future debt structure of the business?
  - The **relative likelihood** of the events giving rise to the risks also needs to be assessed.
  - This can then be combined with the level of impact to prioritise the risks.
    - *High impact, high likelihood* immediate action required
    - *High impact, low likelihood* contingency plan needed
    - *Low impact, high likelihood* consider taking action
    - *Low impact, low likelihood* no action now, but review periodically

Once risks have been prioritised, management needs to decide what to do about them, and how they can be managed and monitored in the future.

Strategies for management of a given risk include:

- Acceptance
- Transfer e.g. by insurance or joint venture
- Elimination by hedging, or ceasing the activity/operation
- Control by building in operational controls

8 COSO Framework

(a) **Avoidance** means exiting the activities that give rise to risk. Risk avoidance may involve disposing of a business unit, product line, or geographical segment, or simply deciding not to engage in new initiatives/activities that would give rise to the risks.

If **reduction** is the chosen response then action is taken to reduce risk likelihood or impact, or both. This typically involves any of a large number of everyday business decisions, including diversifying product offerings, establishing operational limits for activities, establishing more effective business processes, enhancing management involvement in decision making and monitoring, rebalancing the entity's portfolio of assets to reduce exposure to certain types of losses, or reallocating capital among operating units.

Sharing entails reducing risk likelihood or impact by **transferring** or otherwise sharing a portion of the risk. Common techniques include purchasing insurance products, engaging in hedging transactions, entering into joint ventures or partnerships, sharing risk through contractual agreements with customers, vendors, or other business partners, or outsourcing an activity.

If **acceptance** is the chosen response no action is taken to affect risk likelihood or impact: the risk is accepted because it already conforms to the entity's risk tolerances. The entity may have self-insured against loss, or it may rely upon natural offsets within a portfolio.

(b) Control activities are the actions of people to implement policies, directly or through application of technology, in such a way as to help ensure that management's risk responses are carried out.

Many procedures are commonly performed by personnel at various organisational levels that serve to enforce adherence to established action plans and to keep entities on track toward achieving their objectives.

Here are some examples.

- **Top-level reviews** – Senior management reviews actual performance versus budgets, forecasts, prior periods, and competitors. Major initiatives, such as marketing thrusts, improved production processes, and cost containment or reduction programmes, are tracked to measure the extent to which targets are being reached.

- **Direct functional or activity management** – Managers running functions or activities review performance reports. For example, a manager responsible for a bank's consumer loans will review reports by branch, region, and loan type, checking summaries and identifying trends, and relating results to macro-economic statistics and targets. Managers will also focus on compliance issues, for example reviewing reports required by regulators on new deposits over specified amounts.

- **Information processing** – A variety of controls are performed to check accuracy, completeness, and authorisation of transactions. Data entered is subject to on-line edit checks. A customer's order, for example, is accepted only after reference to an approved customer file and credit limit. Numerical sequences of transactions are accounted for, with exceptions followed up and reported to supervisors. Development of new systems and changes to existing ones are controlled, as is access to data, files, and programs.

- **Physical controls** – Equipment, inventories, securities, cash, and other assets are physically secured and periodically counted and compared with amounts shown on control records.
- **Performance indicators** – Relating different sets of data (operating or financial) to one another, together with analyses of the relationships and investigative and corrective actions, serves as a control activity. Performance indicators include, for example, staff turnover rates by business unit. If they investigate unexpected results or unusual trends, management may identify circumstances where an insufficient capacity to complete key processes may mean that there is a risk that objectives have a lower likelihood of being achieved.
- **Segregation of duties** – Duties are divided, or segregated, among different people to reduce the risk of error or fraud. For instance, responsibilities for authorising transactions, recording them, and handling the related asset are divided. A manager authorising credit sales would not be responsible for maintaining accounts receivable records or handling cash receipts. Similarly, salespeople would not have the ability to modify product price files or commission rates.

9 Ethical considerations

To: The Managing Director
From: The Financial Controller
Date: XX.XX.XX
Subject: Issues arising from the meeting with X Ltd regarding payment of their debt

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This report assumes that you have read the enclosed documents prepared by the Sales Director concerning her recent meeting with Y, the Managing Director of X Ltd. In brief, we are being asked to supply further materials on credit to X Ltd on the understanding that this offers our best chance of being paid both for long-outstanding existing debts and the further debts that will arise.

Firstly I need to point out that our Sales Director feels that we should accept what has been informally agreed but she has openly admitted that she has difficulty in taking an objective view of the situation, having done business with Y for many years.

However, the agreement that is being proposed leaves me with grave doubts, both on ethical grounds and from the point of view of the business.

Our options are:

- to accept the agreement as proposed;
- to refuse the payment from Y but supply further materials in any case;
- to sue for payment or simply write off the debt.

Accepting the agreement

This option puts us in a position where we are owed (and are at risk of losing) not only our existing debt of £A but also a further amount (say £B, based on past trading experience).

I am not sure what the role of the personal payment is meant to be. It is not a bribe, although it has that taste about it, since the intention is that it would be repaid. Presumably it is a sign of good faith, but why not inject the funds directly into the company and pay off some debts now? If Y is not willing to risk loaning the funds to his company, why should we be any more willing to take the risk of supplying further goods?

In any case, recovery of our debt depends not only on our support but also that of all or almost all of X Ltd's other suppliers. We have no guarantee that this support will be forthcoming. (Indeed, I have just

received a telephone message from another supplier indicating that they too are worried about X Ltd's position, and asking for our view (see below).)

If the company is forced into liquidation by other creditors (or if X Ltd cannot complete the next stage of the work) what are we expected to do about the personal payment? I am not sure how the law would view it. It would put us in a more advantageous position than other creditors, but unfairly so.

There are other matters that cause me to have doubts.

- Why can X Ltd not obtain an advance from their bank against the promise of the next progress payment? Has this option been attempted? If not, is the bank fully aware of the difficulties of X Ltd?
- Are X Ltd already *'trading wrongfully'*, which is illegal? To knowingly enter into an agreement that allows this to continue calls our own integrity into question.

Refuse the payment but supply the materials

This is a better option because it leaves us with a clear conscience regarding the payment, and does not compromise Y in any way. The other problems remain, however.

We need to be assured:

(a) that X Ltd can secure the support of its other creditors
(b) that X Ltd really can complete the next stage of the contract

If we are satisfied on point (a), we could encourage X Ltd to enter into negotiations with all of its suppliers. We can let it be known that we will be willing to help if others are: this will put X Ltd in a stronger position.

If X Ltd is able to get the level of support needed, this option is the one that I recommend.

If both you and Y agree to this I may have an immediate opportunity to help out, since (as I mentioned) I have already had an enquiry from an acquaintance working for another supplier who will also, I think, be keen to salvage something from the situation if at all possible.

Confidentiality is an issue at present, so for the time being I have sent a fax explaining that we are currently negotiating with X Ltd and that I will be in touch once I know the outcome of our talks. (You will realise that my own professional integrity could be compromised if I supply information that could be considered misleading. I cannot simply ignore the enquiry or be cagey about it since this could itself be construed as a 'bad' reference.)

Suing for payment or writing off the debt

Since we are unlikely to recover our debt this option will simply increase our loss because we will have to pay legal costs. X Ltd may be counting on the fact that we know this.

One possible virtue of this option is that the threat of liquidation, or liquidation itself, may force Y to come to an arrangement with all creditors if we are unable to persuade him to try this by other means.

Writing off the debt now has the virtue that we do not risk losing a further amount by supplying more materials. On the down side, it could make us look 'soft' to other customers, and it is possibly unduly harsh not to give X Ltd a chance to recover the situation. It is not in our long-term interests for our customers to go out of business.

I cannot recommend either of these options except in the very last resort.

Wider issues

We need to consider whether this situation has arisen due to problems with credit control on our part. It could perhaps be argued that we should have worked more closely with X Ltd to prevent the problem arising in the first place. We should have been aware that X Ltd was taking on a much larger contract than it has previously been used to dealing with and we should have anticipated problems.

Over the next few days I shall be looking into ways in which our credit control systems can be adapted to ensure that external matters such as this are taken into account.

10 Corporate citizenship

REPORT

To: Directors
From: Consultant
Date: Dec X4
Subject: Corporate citizenship

Introduction

Companies have choices as to how they manage their businesses. These choices can be many and varied but the choices that are made can determine whether or not the company is seen as a good citizen. Many of the world's companies are setting high standards of behaviour in many aspects of business and in a wider social context.

Corporate citizenship

The concept of corporate citizenship recognises that there is a connection between the everyday activities of companies and the well being of society as a whole. In recent years companies have adopted a more comprehensive approach to corporate citizenship in general, and this includes social and environmental responsibility.

Directors now accept that they are not only responsible to the shareholders – the owners of the company – but also to a wider selection of other stakeholders which will include employees, customers, investors, business partners, suppliers, the community and the government.

It can be argued that corporate citizenship is made up of three key components:

(1) the basic values, policies and practices of a company and its business at home and abroad
(2) the management of environmental and social issues within the value chain of business partners
(3) the voluntary contributions made by a company to community development around the world

Social and environmental issues that may affect companies

The types of social and environmental issues that may affect companies can most easily be considered by taking a look at the various stakeholders in a company and issues that might affect the relationship of the company with those stakeholders.

- **Employees**. Issues that may affect employees and the company's treatment of those employees include wage rates, health and safety provisions, accident rates, training opportunities and how changes such as downsizing and redundancies are handled.
- **Customers**. Customers in global, competitive markets are increasingly concerned not only with price but also value of goods and services. Quality issues are paramount to most companies including how complaints are handled. Increasingly customers are also concerned with the background to the goods they have purchased and the conditions under which they were manufactured. In an age of environmental concerns customers are also concerned with factors such as the safe disposal or recycling of products once used.
- **Suppliers**. The activities of one company will necessarily have a knock-on effect on other companies with which it deals, in particular suppliers. Companies will be concerned about the long-term stability of their suppliers, the sustainability of jobs at their suppliers and timely payment of their suppliers.
- **The community**. Concerns here for a company will centre on charitable gifts and donations, the support of employees providing charitable gifts or services, investment within the community and the willingness to listen to community concerns and to enter into meaningful dialogue.

- **Government**. Many companies pay huge amounts of taxes, which are vital for the sustainability, and growth of many countries and economies. Companies should be concerned with issues such as fair transfer pricing policies and compliance with the laws and regulations of all the countries within which they operate.
- **Environment**. Increasingly the general environment is being viewed as an additional stakeholder and the quality of the management of environmental issues over the entire product life cycle will be of great importance to companies.

Ethical issues that a board may face

Once it is accepted that modern day companies are not only in business to increase shareholder wealth but also to protect and nurture society and the environment then there are many potential ethical issues that may face a board of directors in their strategies and operational decision making.

Directors may need to consider all aspects of their value chain, both backward linkages and forward linkages. Backward linkages may include ethical issues such as the conditions in which products are made in many developing countries, i.e. low wages, poor conditions, child labour, etc as these are fast becoming important issues for customers.

Manufacturers of products also have to accept that their responsibility in the customer's eyes does not end with the sale of the product. Directors will need to consider their products over their entire life cycle and in particular environmental issues such as the safe disposal of products, recycling of products and the restoration of the environment when manufacture or use is complete.

Directors must also be concerned with social and ethical issues particularly in association with products such as alcohol, cigarettes or pharmaceuticals. The directors of such companies will need to be particularly aware of social responsibility issues such as under-age drinking, drink driving, the dangers of smoking and the misuse of prescription pharmaceuticals. This will often affect the ways and methods in which such goods are advertised.

Companies should also accept that they have ethical responsibilities towards their employees, particularly in developing countries, in terms of wage rates, working conditions, provision of health care and pension arrangements.

Directors of companies may find that they are faced with ethical decisions when considering voluntary contributions to the societies in which they operate. Many donations promoting the common good may have no apparent tangible benefits to the company itself but the reputation of being a 'caring company' must not be under-estimated.

END OF ANSWER BANK

Appendix A
Pilot paper questions

Pilot paper

Paper P1

Professional Accountant

Time allowed

Reading and planning: 15 minutes
Writing: 3 hours

This paper is divided into two sections:

Section A – This ONE question is compulsory and MUST be attempted

Section B – TWO questions ONLY to be attempted

Do NOT open this paper until instructed by the supervisor.

During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.

This question paper must not be removed from the examination hall.

Warning

The pilot paper cannot cover all of the syllabus nor can it include examples of every type of question that will be included in the actual exam. You may see questions in the exam that you think are more difficult than any you see in the pilot paper.

SECTION A: This question is compulsory and MUST be attempted

Question 1

Chemco is a well-established listed European chemical company involved in research into, and the production of, a range of chemicals used in industries such as agrochemicals, oil and gas, paint, plastics and building materials. A strategic priority recognised by the Chemco board some time ago was to increase its international presence as a means of gaining international market share and servicing its increasingly geographically dispersed customer base. The Chemco board, which operated as a unitary structure, identified JPX as a possible acquisition target because of its good product 'fit' with Chemco and the fact that its geographical coverage would significantly strengthen Chemco's internationalisation strategy. Based outside Europe in a region of growth in the chemical industry, JPX was seen by analysts as a good opportunity for Chemco, especially as JPX's recent flotation had provided potential access to a controlling shareholding through the regional stock market where JPX operated.

When the board of Chemco met to discuss the proposed acquisition of JPX, a number of issues were tabled for discussion. Bill White, Chemco's chief executive, had overseen the research process that had identified JPX as a potential acquisition target. He was driving the process and wanted the Chemco board of directors to approve the next move, which was to begin the valuation process with a view to making an offer to JPX's shareholders. Bill said that the strategic benefits of this acquisition was in increasing overseas market share and gaining economies of scale.

While Chemco was a public company, JPX had been family owned and operated for most of its thirty-five year history. Seventy-five percent of the share capital was floated on its own country's stock exchange two years ago, but Leena Sharif, Chemco's company secretary, suggested that the corporate governance requirements in JPX's country were not as rigorous as in many parts of the world. She also suggested that the family business culture was still present in JPX and pointed out that it operated a two-tier board with members of the family on the upper tier. At the last annual general meeting, observers noticed that the JPX board, mainly consisting of family members, had 'dominated discussions' and had discouraged the expression of views from the company's external shareholders. JPX had no non-executive directors and none of the board committee structure that many listed companies like Chemco had in place. Bill reported that although JPX's department heads were all directors, they were not invited to attend board meetings when strategy and management monitoring issues were being discussed. They were, he said, treated more like middle management by the upper tier of the JPX board and that important views may not be being heard when devising strategy. Leena suggested that these features made the JPX board's upper tier less externally accountable and less likely to take advice when making decisions. She said that board accountability was fundamental to public trust and that JPX's board might do well to recognise this, especially if the acquisition were to go ahead.

Chemco's finance director, Susan Brown advised caution over the whole acquisition proposal. She saw the proposal as being very risky. In addition to the uncertainties over exposure to foreign markets, she believed that Chemco would also have difficulties with integrating JPX into the Chemco culture and structure. While Chemco was fully compliant with corporate governance best practice, the country in which JPX was based had few corporate governance requirements. Manprit Randhawa, Chemco's operations director, asked Bill if he knew anything about JPX's risk exposure. Manprit suggested that the acquisition of JPX might expose Chemco to a number of risks that could not only affect the success of the proposed acquisition but also, potentially, Chemco itself. Bill replied that he would look at the risks in more detail if the Chemco board agreed to take the proposal forward to its next stage.

Finance director Susan Brown, had obtained the most recent annual report for JPX and highlighted what she considered to be an interesting, but unexplained, comment about 'negative local environmental impact' in its accounts. She asked chief executive Bill White if he could find out what the comment meant and whether JPX had any plans to make provision for any environmental impact. Bill White was able to report, based on his previous dealings with JPX, that it did not produce any voluntary environmental reporting. The Chemco board broadly supported the idea of environmental reporting although company secretary Leena Sharif recently told Bill White that she was unaware of the meaning of the terms 'environmental footprint' and 'environmental reporting' and so couldn't say whether she was supportive or not. It was agreed, however, that relevant information on JPX's environmental performance and risk would be necessary if the acquisition went ahead.

Required

(a) Evaluate JPX's current corporate governance arrangements and explain why they are likely to be considered inadequate by the Chemco board. **(10 marks)**

(b) Manprit suggested that the acquisition of JPX might expose Chemco to a number of risks. Illustrating from the case as required, identify the risks that Chemco might incur in acquiring JPX and explain how risk can be assessed. **(15 marks)**

(c) Construct the case for JPX adopting a unitary board structure after the proposed acquisition. Your answer should include an explanation of the advantages of unitary boards and a convincing case FOR the JPX board changing to a unitary structure. **(10 marks)**

(d) Explain FOUR roles of non-executive directors (NEDs) and assess the specific contributions that NEDs could make to improve the governance of the JPX board. **(7 marks)**

(e) Write a memo to Leena Sharif defining 'environmental footprint' and briefly explaining the importance of environmental reporting for JPX. **(8 marks)**

(Total = 50 marks)

Question 1

This question is an example of what's likely to be a common type of question on this paper, evaluate the inadequacies and suggest improvements. However parts (c) and (d) are quite specific about which areas you have to discuss, indicating you need a detailed knowledge of corporate governance issues to underpin your discussions. The question part on risk is mixed in with this discussion on corporate governance, indicating how different parts of the syllabus will be combined in the case study question.

This question covers material from a number of chapters, and you can expect Question 1 to be drawn from areas covered across the whole of your Study Text.

Section B: TWO questions ONLY to be attempted

Question 2

In a recent case, it emerged that Frank Finn, a sales director at ABC Co, had been awarded a substantial over-inflation annual basic pay award with no apparent link to performance. When a major institutional shareholder, Swanland Investments, looked into the issue, it emerged that Mr Finn had a cross directorship with Joe Ng, an executive director of DEF Co. Mr Ng was a non-executive director of ABC and chairman of its remunerations committee. Swanland Investments argued at the annual general meeting that there was "a problem with the independence" of Mr Ng and further, that Mr Finn's remuneration package as a sales director was considered to be poorly aligned to Swanland's interests because it was too much weighted by basic pay and contained inadequate levels of incentive.

Swanland Investments proposed that the composition of Mr Finn's remuneration package be reconsidered by the remunerations committee and that Mr Ng should not be present during the discussion. Another of the larger institutional shareholders, Hanoi House, objected to this, proposing instead that Mr Ng and Mr Finn both resign from their respective non-executive directorships as there was "clear evidence of malpractice". Swanland considered this too radical a step, as Mr Ng's input was, in its opinion, valuable on ABC's board.

Required

(a) Explain FOUR roles of a remuneration committee and how the cross directorship undermines these roles at ABC Co. **(12 marks)**

(b) Swanland Investments believed Mr Finn's remuneration package to be 'poorly aligned' to its interests. With reference to the different components of a director's remuneration package, explain how Mr Finn's remuneration might be more aligned to shareholders' interests at ABC Co. **(8 marks)**

(c) Evaluate the proposal from Hanoi House that both Mr Ng and Mr Finn be required to resign from their respective non-executive positions. **(5 marks)**

(Total = 25 marks)

Question 2

This question has some similiarities to Question 1, requiring knowledge of specific areas of good corporate governance practice and application of that knowledge to identify weaknesses and recommend improvements. Ethics part (c) is only worth 5 marks; you may well encounter more complex ethical situations requiring discussion worth more marks.

Chapter 3 of your Study Text thoroughly covers the issues involved in this question.

Question 3

At a recent conference on corporate social responsibility, one speaker (Professor Cheung) argued that professional codes of ethics for accountants were not as useful as some have claimed because:

"they assume professional accountants to be rules-driven, when in fact most professionals are more driven by principles that guide and underpin all aspects of professional behaviour, including professional ethics."

When quizzed from the audience about his views on the usefulness of professional codes of ethics, Professor Cheung suggested that the costs of writing, implementing, disseminating and monitoring ethical codes outweighed their usefulness. He said that as long as professional accountants personally observe the highest values of probity and integrity then there is no need for detailed codes of ethics.

Required

(a) Critically evaluate Professor Cheung's views on codes of professional ethics. Use examples of ethical codes, where appropriate, to illustrate your answer. **(12 marks)**

(b) With reference to Professor Cheung's comments, explain what is meant by 'integrity' and assess its importance as an underlying principle in corporate governance. **(7 marks)**

(c) Explain and contrast a deontological with a consequentialist based approach to business ethics. **(6 marks)**

(Total = 25 marks)

Question 3

More an essay than a scenario-based question, but a clear illustration that you will be expected to discuss ethical theory without necessarily having to apply it to a practical scenario.

Chapter 11 of your Study Text covers the areas you need to discuss in this question.

Question 4

As part of a review of its internal control systems, the board of FF co, a large textiles company, has sought your advice as a senior accountant in the company.

FF's stated objective has always been to adopt the highest standards of internal control because it believes that by doing so it will not only provide shareholders with confidence in its governance but also enhance its overall reputation with all stakeholders. In recent years, however, FF's reputation for internal control has been damaged somewhat by a qualified audit statement last year (over issues of compliance with financial standards) and an unfortunate internal incident the year prior to that. This incident concerned an employee, Miss Osula, expressing concern about the compliance of one of the company's products with an international standard on fire safety. She raised the issue with her immediate manager but he said, according to Miss Osula, that it wasn't his job to report her concerns to senior management. When she failed to obtain a response herself from senior management, she decided to report the lack of compliance to the press. This significantly embarrassed the company and led to a substantial deterioration in FF's reputation.

The specifics of the above case concerned a fabric produced by FF Co, which, in order to comply with an international fire safety standard, was required to resist fire for ten minutes when in contact with a direct flame. According to Miss Osula, who was a member of the quality control staff, FF was allowing material rated at only five minutes' fire resistance to be sold labelled as ten-minute rated. In her statement to the press, Miss Osula said that there was a culture of carelessness in FF and that this was only one example of the way the company approached issues such as international fire safety standards.

Required

(a) Describe how the internal control systems at FF Co differ from a 'sound' system of internal control, such as that set out in the Turnbull guidance, for example. **(10 marks)**

(b) Define 'reputation risk' and evaluate the potential effects of FF's poor reputation on its financial situation. **(8 marks)**

(c) Explain, with reference to FF as appropriate, the ethical responsibilities of a professional accountant both as an employee and as a professional. **(7 marks)**

(Total = 25 marks)

Question 4

An illustration that Section B questions may cover topics from across the syllabus, even though there isn't the emphasis that there is for Section A questions on linking those different areas. Again part (a) is an identify the problems requirement, although here you aren't expected to recommend improvements in detail. Part (b) illustrates that you might be asked questions about a specific risk rather than be expected to cover the range of key risks that an organisation faces.

Chapters 4, 6 and 11 of your Study Text between them deal with the issues you need to include.

END OF APPENDIX A